The New York Certified Public Accountant

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Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

New York State Society of Certified Public Accountants

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Awards in the 1954 Prize Essay Contest

First Prize—"A Case Study in Cost and Expense Reduction for a Large Electrical Equipment Manufacturer"
by James P. McCully

Second Prize—"Tax Accounting and Book Accounting: '—and Never the Twain Shall Meet' "
by Brenda B. Webb

Third Prize (tie)—"Appraisal of Clients' Internal Control Systems by Independent Public Accountants"
by Richard Schwartz
and
"Cost Accounting for the Chemical Industry with Particular Reference to Joint-Product and By-Product Accounting"
by Walter E. Lewin

AN ADIRONDACK VIEW

Thanksgiving comes but once a year—to most of you. But to many of us, near the border, we get it twice—well, almost twice! Canada's Thanksgiving Day comes in October—the eleventh, this year, the second Monday. And our neighbors use this week-end for holiday and shopping trips—and we, too, are thankful.

But our big office thanks come each year when:

1. Our "errors and omissions" are small ones.

2. We find them ourselves.

3. Those that slip through are in work for clients that are good humored—well, at least reasonably so.

We hope most of you have been smart, or lucky, enough to join in these thanks.

And while we are laying on the line the things we are thankful for, in a business way, there is another one we are apt to forget—the many officers and others in our State Society who give so much energy and time to the Society. So, we say—**Thank you, real good!**

LEONARD HOUGHTON, C.P.A.
"Adirondack Chapter"

BOOK REVIEWS

Apportionment and Allocation Formulae and Factors Used by States in Levying Taxes Based on or Measured by Net Income of Manufacturing, Distributive and Extractive Corporations.

By Albert H. Cohen, of the Bureau of Business Research, University of Michigan. CONTROLLERSHIP FOUNDATION, INC., New York, N. Y., 1954. Pages: 73 (6 x 9, paper cover); $1.50.

This research study was made in order (1) to present an analysis of formulae used by the several states in levying taxes measured by or based on net income, (2) to report on the diversity, inconsistency and contradictions of these formulae, (3) to point up the inequities of such diversity, (4) to determine the common elements in these formulae, and (5) to reveal sound, equitable factors and definitions in various apportionment formulae. The data studied were obtained from tax service reports, interviews with controllers and tax executives of corporations, and a questionnaire distributed among members of Controllers Institute of America.

The report is presented under the following chapter headings:

I—General Statement of Problem

II—Separate Accounting and Specific Allocation of Certain Classes of Income

III—Apportionment of Income by Statutory Formula

IV—Definitions of Apportionment Factors

V—Tax Administration under the Present System

VI—Questionnaire Results

In addition, an appendix is included in which there are presented, with respect to the several states, (1) an analysis showing how the several states require specific items to be allocated, and (2) a summary of apportionment formulae. Tables and charts are used to set forth some of the findings in a more visual manner.

For the experienced practitioner the study serves to emphasize the problems of which he already has become aware; for the practitioner of lesser experience, the study serves to point up problems which will confront him from time to time; for the taxpayers and taxing jurisdictions, the study serves to indicate the need for greater uniformity in apportionment procedures, definitions, interpretations, and enforcement procedures.

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BOOK REVIEWS

(Continued from page 664)

Without a thorough understanding of the rules followed by those states which attempt to tax the income of out-of-state companies doing business within their borders, and of the inconsistent and overlapping laws, an orderly approach to a possible solution of the problem or to the improvement of the existing conditions, is made very difficult. The report presents the facts so that interested persons may be induced to take the action necessary for obtaining more uniform laws and administration.

STANLEY B. TUNICK

New York, N. Y.

Business Applications of Electronic Machines: An Annotated Bibliography

CONTROLLERSHIP FOUNDATION, INC., New York, N. Y., 1954. Pages: viii + 46; $2.00 ($1.50 to members of Controllers Institute).

This booklet is made up of three parts: a reading list, in three sections; a list of manufacturers of electronic machines and auxiliary equipment, as well as places at which the machines have been installed; and a list of educational training programs, seminars, and conferences concerning electronic equipment.

The readings have been screened out from the "veritable flood of published material about business applications of electronic machines." Following a "Suggested Basic Reading List", are presented 22 pages of annotated material on electronics: periodicals, pamphlets and special reports, books, and company releases are reviewed. Five other pages deal with business applications of electro-mechanical, rather than electronic, equipment. These references are provided "because the applications which they describe are considered . . . definite transitional steps towards use of electronic equipment and procedures."

The Foundation contacted over 100 business firms in developing the section on machine manufacturers and installations. Page 29 indicates how to go about arranging to see the machines in operation in the field.

This brief work, and the projected periodic supplementary releases, should be of considerable use to accountants concerned with the application of electronic machines to office operations.

LEO ROSENBLUM

Bernard M. Baruch School of
Business and Public Administration
The City College of New York

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BUSINESS AND PERSONNEL OPPORTUNITIES

(Continued from page 668)

BUSINESS OPPORTUNITIES (Continued)

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BUSINESS AND PERSONNEL OPPORTUNITIES

(Continued from page 669)

SITUATIONS WANTED (Continued)

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BOOK REVIEWS

(Continued from page 666)

Thirty Years to Win

By Paul E. Bacas, Richard R. Smith Publisher, Inc., Topside, West Rindge, New Hampshire, Pages: 209; $3.00.

Sitting in retirement, Paul Bacas surveys the contemporary scene and finds little to his liking. He is disturbed by the attitudes of children, employees, professional men, politicians, clergymen, educators and labor leaders. He yearns to do something about tall buildings, traffic congestion, informal dress, tobacco smoking and radio and television commercials. In fact, he seems to have serious doubts that the United States of America is a great country.

The solution proposed is a patriotic organization called "America the Substantial." Control of the association is to rest in individuals not actively associated with special movements which endeavor to promote the interests of certain groups. The principles of the movement, of which there are many, range from the very broad, such as: "Life Should Be Enjoyed", "Human Nature Should Be Controlled" and "The Public Should Not Be Irritated Unnecessarily," to the specific: "Lawyers Should Work for the Good of the Public", "Physicians Should Observe Professional Standards" and "Former Presidents Should Be Senate Members."

Projecting himself forward to the year 1983, the author writes in retrospect and finds that while the millenium has not arrived, attitudes and conditions are much improved. "The United States of America is once more considered to be one of the leading countries of the world."

Frank A. Dunn

New York, N. Y.

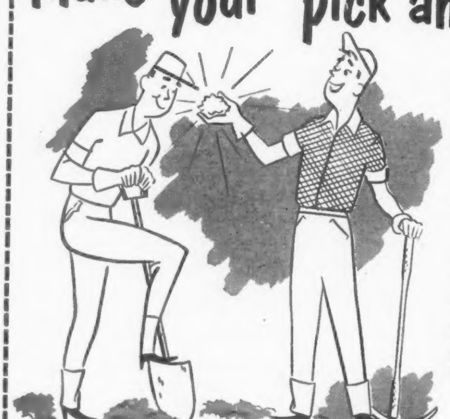
J. K. Lasser's Your Income Tax

(1955 Edition, for preparing 1954 returns) By J. K. Lasser Tax Institute (Sydney Prerau, Director and Editor). Simon and Schuster, Inc., New York, N. Y., 1954. Pages: iv + 203; $1.95.

This is the eighteenth edition of this annual best-seller, completely revised to reflect the sweeping changes made by the new 1954 tax law. Fortunately, Mr. Prerau continues the Lasser tradition for clarity and succinctness of expression in this highly technical field. The regular reappearance of this valuable and widely-used tax guide is thus assured, for which both taxpayers and their advisers should be duly thankful.

E. S.

(Continued on page 716)



THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The President's Page

Tax Practice—III

IN last month's "President's Page" we noted that the public, on its own, has naturally gravitated to the accountant for preparation of income tax returns, tax planning work, and administrative review of returns.

The public has, with the same naturalness, flocked to the lawyer when tax cases had to be litigated. Why?

In a court proceeding the all-important factor is presentation. This sets in motion all sorts of rules and procedures where the lawyer, and the lawyer alone, is king-pin. The underlying problem remains that of income determination, but before that is reached there are supervening matters of jurisdiction, pleadings, rules of evidence, art of examination and cross-examination, etc., etc., where the accountant, doctor, engineer, or theologian are as much at sea as the client himself. But the lawyer is trained to live and flourish in that atmosphere.

Even then, it is interesting to note that because income determination is at the heart of a tax case, the public has been told by the Congress and The Tax Court of the United States that the CPA may conduct a trial in that court, if the public prefers him. By and large, the public has preferred the lawyer.

The point is that the line of cleavage in income tax practice is clear as to where the accountant leaves off and the lawyer begins. As long as the dominant thing is income determination, and that's what it is in tax planning, return preparation, or administrative discussion of the return, the accountant is and should be the major-domo. However, where the dominant thing is the formal arena and related formal presentation—which in turn gets back to the rules of evidence, and the whole art of trial work—the lawyer is and should be in command.

This does not mean that the public is best off bringing every income tax problem, short of litigation, to the accountant. An accountant has no special virtuosity in the vast area dealing with enforcement of tax liability as distinguished from the determination of tax liability. Where the crucial element is the substantive accounting phase, the accountant "belongs". Where the crucial element is the adjective legal phase, the lawyer "belongs".

It is not a matter of how difficult or doubtful the problems involved are. As a matter of fact, the more difficult and doubtful the income determination problems, the more urgent it is that the accountant reign supreme. Conversely, the more difficult and doubtful the legal area, the more important it is that the lawyer rule the roost.

What evaluation shall be given this sort of syllogism: The lawyer is the ideal professional in tax litigation. What is done administratively may affect the litigation. Therefore, the lawyer is the ideal professional in the administrative phases as well.

The flaw is apparent. Litigation does not exist for the lawyer, but vice-versa. Otherwise, he might just as well displace the businessman whose activities give rise to the transaction in the first instance.

In the next issue, we'll try to summarize where we stand, and where we go, on the subject of tax practice.

J. S. SEIDMAN

Accounting Aspects of Oil and Gas Production

By George W. Lafferty, C.P.A.

This paper discusses the major accounting problems encountered in the exploration, discovery and production of oil and gas by a moderate-sized company employing a manually-operated accounting system.

Introduction

This article represents the first paper in a series of three, designed to set forth the essential elements necessary to the accounting control of oil and gas operations. The field of oil and gas accounting is a broad one and covers many different types of functions in its operations. There is set forth below an outline of the operating, or functional areas, which might be encountered in an integrated oil and gas producer.

It is desired to point out that the scope of this first article will be limited to those problems of accounting control which are present in the areas of exploration, discovery and production, with the problems of transportation to refinery, refining and ultimate distribution to consumer being deferred to a subsequent article. It is to be added that no great difference, from the standpoint of accounting exists in respect to gas production and oil production up to the point where the mineral is taken out of the earth. The term mineral is applied as oil and gas are generally considered a mineral resource.

George W. Lafferty, C.P.A. (Texas), is associated with the firm of Cheatham, Brady & Co., CPA's, Houston, Texas, in the capacity of Manager. He is chairman of the Committee on Accounting Procedure of the Texas Society of CPAs, and is Editor of the Questions and Answers column of *The Texas Certified Public Accountant.*

Dr. Lafferty earned the degree of Ph.D. at the University of Texas, and was formerly a member of the Accounting staffs of the University of Alabama, the University of Texas, and Columbia University.

He has previously written for our publication, as well as for the *Journal of Accountancy,* the *N.A.C.A. Bulletin, The Accounting Review* and *The Internal Auditor.*

Functional Processes Involved in Oil and Gas Operations

Oil

- Exploration.
- Drilling and discovery.
- Development of properties.
- Storage of production on lease.
- Transmission of lease storage to either crude tank farm or to refinery.
- Refining of crude with production of various refined products such as gasoline, fuel oils and higher end products as Butanes and Propanes.
- Transmission of refined products to storage capacities at refined product tank farms.
- Transmission to marketing terminals via barge, tank car, pipeline, or tanker.
- Transmission from marketing terminal to bulk plant or wholesaler.
- Transmission to commercial user or service station outlets.

Gas

- Exploration.
- Drilling and discovery.
- Development of properties.
- Transmission of gas into pipeline.
- Functions from this point on, for the most part, are within area of pipeline transmission company, which problems will be deferred to a later discussion.

It is impossible, within the available limits of an article of this nature, to cover all the various accounting ramifications to be found in the exploration, discovery, and production of oil and gas. Accordingly, the article will deal with the major problems that must be met and will illustrate some of the major records that should be maintained. The information as set forth will be based on the activities of a small oil and gas operation and will be representative of a manually-operated system of accounting. It is to be observed, however, that such manual system can be readily adapted to any of a number of machine systems in those instances where the volume of operations so requires. Further, it is worthy of note in the production of oil and gas that up to the point of lease storage, the problems of the little operator and the big operator are the same, the big operator simply has a larger volume of the same problems.

Impact of Federal Income Tax Treatment on Accounting

As in the case of other industries, governmental regulation of one type or another has had a serious impact on the types of records that must be maintained. This is particularly so in the area of drilling and development, where federal income tax requirements applicable to other industries would require capitalization of costs up to the point of the creation of an economic asset. However, such is not the case in oil and gas where the federal Internal Revenue Code recognizes the economic risks involved in oil and gas explorations, and permits the current charge-off of such expenditures against current income (subject to regulations, of course) during the year incurred. Records must be maintained which will permit proper treatment of such expenditures, both taxwise and in the financial statements.

Another important area affected by federal income tax requirements is in the computation of depletion allowances. Federal income tax procedure permits the use of either cost depletion or a statutory allowance of 27½ per cent of the gross income from a specific lease or an amount not in excess of the smaller of such 27½ per cent or 50 per cent of the net income from the lease. There are instances where tax advantage can be gained through the use of cost depletion rather than statutory depletion and, accordingly, the accounting records must be so designed as to produce the required information, when needed, without a great deal of re-working of accounting data.

The foregoing effects of federal income taxation on accounting requirements of oil and gas producers are set forth here in order to alert the reader to the fact that such pressures are present in oil and gas accounting. The manner in which particular techniques may be utilized will be set forth in greater detail in subsequent portions of this article. It is further desired, by these illustrative points, to emphasize the continual force of federal tax legislation and regulation on accounting requirements. Although it might be considered desirable to attempt to divorce the two for purposes of an article of this type, this is not possible and, accordingly, constant reference will be made in the course of this article to the effect on the accounting procedures of federal income tax requirements.

Impact of State Requirements on Accounting Procedures

Prior to a discussion of the accounting requirements of an oil and

gas producer, it is deemed advisable to remark briefly on those procedures made necessary by virtue of state legislation. In most states, which have oil and gas production, there will be Commissions which operate as regulatory bodies from the standpoint of conservation of a natural resource. In Texas, for example, the Railroad Commission has, as one of its major functions, the regulation of oil and gas production. These Commissions determine the production to be permitted from producing areas during a given month, as well as regulate the initial production allowables from new discoveries. Many factors enter into the determination of such allowables, which are not pertinent to this discussion. The Commissions normally require monthly reports as to production by leases and wells and relation of allowables to actual production for the month. This requirement prescribes that procedures be established for the accumulation of necessary information from the field and the preparation of the required reports to the regulatory Commission.

Another area of state legislative influence lies in the levy of gross production and other types of natural resource taxes on the production of oil and gas. Such levies require monthly reports to the appropriate state department, which show inventory at start, production for month, sales during the month, amounts used in own operations, quantities stored for own operations, and inventory in lease tanks at the end of each month and tax due. Methods and procedures must be developed for accumulating these data and reporting thereon.

Accounting Requirements for Oil and Gas Producers

Exploration

The first step in oil or gas production is exploration. Exploration, in practice, can vary from a simple acquisition of a mineral lease without any preliminary geophysical or geological study, or it can mean that such lease has been acquired only after much scientific exploration has been conducted as to the nature of the subsurface structures.

Modern geophysical procedures are expensive and only established producing companies with substantial resources or well-capitalized new ventures can afford these expenditures. In many instances, leases are acquired, from the companies which conducted the geophysical research, by smaller companies who undertake the development of such properties and agree to give the lessor an overriding royalty out of the working interest as consideration, such royalty being payable only in the event production is obtained. The extent of the royalty interest will depend largely upon the desirability of the property based on the results of the geophysical information available and other known factors, such as proximity to present production and the structural nature of the area covered by the lease.

Lease Acquisition

There follows a number of different methods by which a mineral lease may be acquired, accompanied by an explanation of the manner in which such items should be treated in the accounts.

1. Cash purchase of fee interest including mineral rights.
2. Acquisition in return for development of property—no cash consideration, subject to fee royalty or overriding royalty.
3. Cash consideration and agreement to drill within a stipulated period of time (usually 60 days to one year) subject to forfeiture on failure to drill, with mineral interest subject to a retained royalty in favor of the fee owner. In this instance, no annual delay rentals are paid.
4. Cash consideration and agreement to make further payment out of a percentage of oil produc-

tion up to a stipulated amount, more commonly known as an oil payment, subject to fee owner's royalty and annual delay rentals for primary term of lease.

5. Cash consideration and agreement to pay a certain percentage of gross production to land owner for life of production. The percentage is subject to bargaining but normally is ⅛ of total production, and is known as fee royalty. This lease usually has a primary term of from 5 to 10 years over which annual delay rentals may be paid on a per acre basis in lieu of drilling.
6. Cash consideration and agreement to pay a certain percentage of working interest for life of production. This percentage is what normally is known as an overriding royalty.

It is not to be inferred from the foregoing that these are the only means through which a mineral lease may be acquired. There are others, but these are the ones most commonly encountered. It is further to be observed that in all instances reference is made to unproductive properties at time of acquisition, although similar methods are sometimes applied to productive property purchases.

It is considered necessary at this time to devote a brief amount of space to the nature of an oil or, gas lease. Generally it recites the terms of acquisition and provides for access to the property for purposes of exploration and development. No title to the fee interest is passed as a general rule. The lessee acquires a mineral interest in oil and/or gas. Usually such interest is referred to in terms of 8/8, subject to division into a ⅛ fee royalty to the land owner, payable out of oil or gas production, and ⅞ which is commonly referred to as the working interest. These relationships may vary of course, depending upon the negotiated basis of the lease. The lease will usually further provide for annual delay rentals in the amount of so much per acre, which must be paid annually during the term of the lease as long as it is undeveloped. Failure to meet such annual rentals will result in forfeiture. Another commonly encountered provision is the statement of "primary term" or period over which annual rentals may be paid without negotiation of a new lease.

In the above list of methods for acquiring an oil lease, items 2 and 5 are the usual methods of acquiring from fee owners, whereas items 1, 3, 4, and 6 are the more usually encountered methods of acquiring interests from the original lessees.

The accounting records and accounts required as the result of a lease acquisition are (1) Leasehold Register, (2) Undeveloped Leasehold account, (3) File of Lease instruments, classified according to lease, (4) Delay Rentals Paid account, and (5) Abandoned Lease account.

The Leasehold Register is a very important instrument of control and it should be arranged according to annual rental date and should contain all the basic information pertinent to the lease, as reflected in the lease instruments proper. A Register containing the following columnar headings would provide a satisfactory record for this purpose: Lease Description, Acres Under Lease, Location—State and County. Cash Consideration Paid. Primary Term of Lease. Interest in Gross Production, Working Interest Owned. Annual Delay Rental, 10 columns dated by year—each providing space for recording the date of payment (and check number, if desired) of the successive annual delay rentals actually paid, and Remarks. Alternatively, this Register may be designed so as to have all of the foregoing information (except the annual delay rentals actually paid) on the head of a card, with the record of the annual payments, date and check number, arranged below in vertical fashion.

A TEXAS OIL COMPANY

EXHIBIT I

DRILLING WELLS IN PROGRESS LEDGER (Lease A, Well No. 1)

				Equipment Cost					Intangible Drilling and Development Cost					
Date	Vendor and Description	Posting Reference	F	Total	Pumps and Pump Motors	Casing	Tubing	Misc.	Total	Contract Drilling	Mud and Cement	Labor	Supplies	Misc.

NOTE 1—Modification of the above classifications will be necessary where the company does its own drilling using its own rigs, labor, and supplies. In such cases it may be necessary so to classify expenditures applicable to the particular rig used during the period of drilling and completion as to provide for charges to this account equal to direct costs incurred plus a share of overhead applicable to the rig, inclusive of an appropriate depreciation charge. An alternative, which is often used, is to accumulate rig costs separately and to charge work in progress with what would be the normal contract drilling price. This technique is widely used where outside interest owners participate in the lease development. The offsetting credit will be to rig operating expenses or, alternatively, to an appropriate income account. The net result will be realized reported income to the extent of amounts charged out to outside interest owners.

NOTE 2—Amounts included under Intangible Drilling and Development Costs represent amounts which may be charged off for Federal Income Tax purposes and, accordingly, are segregated for easier determination at the end of year in computing taxable income.

NOTE 3—If only an occasional well is drilled, this ledger may be eliminated and charges made direct to the Lease Investment account or the Well Equipment account.

NOTE 4—Entries hereto may be made from the Voucher Register or the Cash Disbursements book, with appropriate design including a control column for Drilling Wells in Progress charges.

LEASE AND WELL EQUIPMENT LEDGER

EXHIBIT II

Lease Description.. Acres.................. Working Interest Owned.......................

			Lease Equipment					Intangible Drilling and Development Cost						Well Equipment			
Date	Vendor	Ref.	Total	Tanks	Line Pipe	Perm. Bldgs.	Storage Tanks	Total	Contract Drilling	Mud and Cement	Labor	Supplies	Misc.	Total	Pumps & Motors	Casing	Tubing	Misc.

NOTE 1—The reader's attention is called to the similarity between this ledger and the Drilling Wells in Progress Ledger. The accounts in detail in both ledgers should parallel one another, except for Lease Equipment, as Drilling Well Charges and Credits will ultimately be transferred to the Equipment ledger provided production is attained. Accordingly, the original charge-out to drilling wells will provide the necessary breakdown for the bookkeeping transfer to Lease and Well Equipment.

NOTE 2—If desired, separate detail ledgers may be maintained for lease equipment and well equipment.

NOTE 3—A separate depreciation ledger should be maintained in which only summary totals are recorded for purposes of computing depreciation on whichever basis is used. Such ledger is not illustrated.

The Undeveloped Leasehold account should be charged only with cash considerations paid. All other types of consideration mentioned previously represent a severance of economic interest and preferably should not be reflected as a cost on the books of the lessee. If and when the lease becomes commercially productive, the cost applicable to the leasehold should be transferred out to a Leasehold Investment account for ultimate amortization through depletion charges. At any time, the closed-out balance of the Undeveloped Leasehold account should agree with the total of the Leasehold Register "cost of acquisition" column. As in the case with any control account, periodic reconciliations should be made between the control and the detail.

The Delay Rentals Paid account represents an operating expense item and, as such rentals are paid, this account should be charged.

In the event that a lease is dropped for one reason or another the cost of such lease becomes an expense during the year of abandonment and accordingly its cost should be transferred from the Undeveloped Leasehold account to the Abandoned Lease account.

It is desired, at this point, to emphasize the importance of the Leasehold Register as an aid to controlling a drilling and development program. Monthly reviews of this register should be made in order to determine annual rentals coming due and the remaining life of primary lease terms, as well as statistics regarding abandonments. In this manner protection is gained against the loss of valuable properties, and information is provided which can be helpful in making decisions as to which leases should be dropped by virtue of subsequent developments in the lease area.

If major geophysical and geological expenditures are made on the basis of which mineral leases are acquired, such amounts represent a leasehold cost and should be included as part of the lease acquisition cost. Any such costs which do not result in acquisition of a lease should be charged off as an expense in the year of incurrence.

Drilling and Development

Once the lease has been acquired the next step is location of the sites for drilling and actual drilling itself. From an accounting standpoint, the drilling of an oil well is not so very different from the construction of any other asset. It is only necessary to provide the accountant with information as to the costs incurred and the classification of such costs.

There should be established a general ledger account which may be entitled "Drilling Wells in Progress" or some other equally descriptive term. This account should be charged with all costs applicable to drilling of the well. It is important that a subsidiary ledger be maintained for each well, which shows the proper classification of expenditures. This ledger will provide information for later clearing to the Lease and Well Equipment account or the Dry Hole Account, as the case may be. An illustrative form of such ledger appears as Exhibit I on page 678 of this article.

Upon completion of the well as a producer, the applicable costs should be transferred to the Lease and Well Equipment account with detail classification in the same manner as for drilling wells in progress. If the well is dry and no casing is set, all costs should be charged off to the Dry Hole account during the current year. In some instances a dry hole will involve all the steps involved in bringing in a commercial producer up to the point of lifting equipment. In such an event those items having a salvage value should be charged to an inventory account.

As a matter of expediency, from an accounting standpoint, the in progress account may be cleared at six-month intervals if such is practical. If monthly statements are a requisite,

monthly clearance should be made for all completed wells, either as producers or as dry holes.

In the course of oil exploration and discovery it is a quite common practice to spread the risk through one device or another. Some methods in use are outlined below. Their existence gives rise to certain accounting problems which in the main consist of credits to the Drilling Wells account for the portion of the cost to be borne by these associates. The amount of such credits can usually be determined by reference to instruments or letters of agreement reflecting the terms as agreed to between the parties. The offsetting charge should be to an account receivable. If wells are being drilled with associates, it may be desirable to have a separate Drilling Wells in Progress account in order to segregate costs applicable to developments in which there are partners or associates. Such procedure is recommended where the volume of development with partners or associates is of any magnitude.

Methods in Use for Distributing Risks

Joint Ventures

A joint venture exists when one or more partners join hands for the development of a particular lease. In such instance a separate set of records may be maintained for the venture with the distributive shares of each venturer being charged out to him as in a partnership. The charge out should be classified in such a manner as to permit each venturer to place on his own records the information as to classification of drilling and development costs. Separate double-entry records are not always a necessity, as techniques can be applied for segregation on the operator's books of such costs in an account termed Drilling Wells in Progress—Joint Venture with A, B, and C. The proportionate share of each venturer will then be charged out as an account receivable from him. In the writer's opinion, the method to be followed will wholly depend upon the decision reached by agreement between the respective venturers. Either method will accomplish the purpose if properly handled.

Sale of a Portion of Working Interest

In this instance the sale should be handled as for any other asset, with a gain or loss being reflected in the accounts. Subsequent thereto accounting for the new associates should follow the same pattern as that outlined above in the second method for a Joint Venture.

Dry Hole Contribution

A dry hole contribution simply represents an agreement on the part of adjoining lease owners to contribute a certain sum in the event that the hole should be dry. In such cases the Drilling Wells in Progress account should be credited and an account receivable charged for the amount due. These agreements are entered into only in order that risks may be shared, and it is not unusual to find the major part of the drilling costs absorbed by such contributions.

Bottom Hole Contribution

Contributions of this nature differ from dry hole contributions in that they are made irrespective of the results of drilling. They are entered into usually for the purpose of obtaining structural information and proving up properties. Any amounts so due should be credited to Drilling Wells in Progress and charged to the appropriate accounts receivable.

Up to this point, the major accounting factors involved in exploration and discovery have been set forth. The writer wishes to emphasize that all the fine points of accounting have not been covered; rather, the broad general factors have been outlined for the reader's consideration.

Leasehold Investment

This account should be charged only with those costs which represent acqui-

sition costs applicable to producing leases and are recoverable through depletion charges to income.

This account functions solely as a control account and is supported by detail accounts which show the particulars in respect to each lease. An illustrative form of the detail ledger appears below.

Another account to be considered in conjunction with the Leasehold Investment is the Accumulated Provision for Depletion. The credits to this account arise from charges to income for depletion. It can be added, at this point, that depletion charges are normally computed by allocating leasehold costs over estimated recoverable units of oil or gas. Such estimates are subject to adjustment for known changes in recoverable units as determined from time to time.

A TEXAS OIL COMPANY

HOUSTON, TEXAS

Leasehold Investment and Depletion Ledger

Lease Description: — Cost $________
Date Acquired — Est. Recoverable
Name — Units—Bbls or MCF ________
State
County — Depletion per unit ________

Year	Bbls or MCF	Annual Depletion	Accumulated Depletion to End of Year
1954			
1955			
1956			
1957			
1958			
1959			
.			
.			
.			
.			
.			
1969			

It is apparent from the ledger illustrated above that techniques must be used to accumulate monthly information for determining the annual barrels of crude or MCF (thousands of cubic feet) of gas produced. Such information will stem, in the first instance, from production tickets prepared at the well or possibly pipeline runs supplied by purchasers. The accounting department will accumulate such information on a monthly basis and from such record compute the annual production. In the smaller operation the monthly accumulation may be entered on a record attached to the detail card, so as to facilitate computation of the annual depletion charge.

The detail for depletion accumulations appears in the same ledger as is illustrated on page 681. In effect, two control accounts, Leasehold Investment and the Accumulated Provision for Depletion, are supported by this single detail ledger.

The techniques described above are for the determination of cost depletion. Inasmuch as statutory depletion, under the Internal Revenue Code, is often times greater than cost depletion, methods must be available for comparing cost depletion and statutory depletion so that the maximum tax advantage may be gained. Such methods are integrated with income and expense accounting and require that net income per lease be computed exclusive of cost depletion, and net income for each lease then computed on a cost depletion basis and statutory basis, with the most advantageous being selected. The procedures here set forth are necessary only for federal income tax purposes and are ordinarily accomplished on a statistical basis outside of the financial accounts.

Retirements on account of abandonments or the sale of producing properties are handled in accordance with the sound principles applicable to fixed asset accounting in other industries. Cost should be retired from the investment account and the related portion of the Accumulated Provision for Depletion should also be retired. Any gain or loss should be reflected in a gain or loss account as an income or expense item.

Lease and Well Equipment

A control account should be maintained for Lease and Well Equipment of a depreciable nature. If desired, an alternative procedure may be followed. This alternative would be to establish a separate control account for Drilling Costs *per se* and maintain a detail ledger therefore. In such instance, Lease and Well Equipment control will be charged only with items of a tangible nature. Some of the major items which can be charged to this account are as follows: Surface casing, oil string (hole casing), tubing, line pipe, pumps, pump motors, lease tanks, compressors (where gas injection system is used), permanent buildings on lease, valves, fittings, etc., contract drilling costs, and labor, mud, cement and other supplies, used in the completion of wells.

Detail Lease and Well Equipment records should be maintained for each lease and each well on the lease. In such a manner, control over fixed assets may be maintained. An illustration of such a detail card or ledger appears as Exhibit II on page 678 of this article.

Depreciation should be computed on a lease basis in order that income per lease can be determined. There are a number of methods in use in the oil industry for computing depreciation. These are: Units of Production, Straight Line, and Composite Life.

In the writer's opinion, the unit of production method most equitably spreads asset cost over the income life of the lease. However, practically speaking, the straight line method may be the most satisfactory due to its ease of computation. The composite method is widely used among the larger companies due to the large volume of homogeneous assets that are found in the oil industry.

Abandonment and retirement accounting principles are no different in the oil industry than in other industries. Cost and the related accumulated depreciation provision should be retired from the accounts, and gain or loss on disposition reflected therein.

One point which the writer wishes to make, due to the large number of partnerships or joint venture associations entered into is that the asset accounts here discussed, reflect only the ownership portion of the operator or producer. Other interests take up their portion of the cost and related depreciation charges on their own books. This, of course, demands methods which will charge to such partners their appropriate share of the cost upon acquisition.

A technique which can be used for accumulating associates' portion of cost is to charge all costs to a drilling well in progress account and clear that portion which is applicable to other interests from such account into a control account, such as Accounts Receivable—Other Interests. In the event well equipment is added after the well is completed and in production, such amounts will ordinarily be charged directly from the invoice to the account receivable.

The ability of an oil producer to charge off for federal income tax purposes certain costs of a non-salvable nature, known as intangible drilling and development costs, requires that techniques be developed for adjusting the books for tax return preparation. In many instances the smaller operator obviates this problem by simply keeping his records on the federal income tax basis. The writer does not recommend this technique as it does not present an Income Statement or Statement of Financial Condition in accordance with sound financial accounting principles.

In preparation of the federal income tax return, all such charges as described above should be transferred from the asset account and charged to income and, accordingly, any related depreciation charges on such amounts should be cleared from the income statement in tax return preparation.

Inventory

Inventory of oil or gas will consist only of those amounts stored in lease tanks or crude tank farms prior to refining or sale. Gas is ordinarily sold direct to the pipeline company and does not offer an inventory problem in most instances.

There are many aspects to inventorying crude in tanks including consideration of the specific gravity of the crude, the temperature at which the inventory is taken, the basic sediment and water in the storage tank and conversion of readings to API 60° Farenheit temperature, which is the basic temperature to which all measurements are converted, thereby eliminating temperature variations as a factor in measurement. Such inventory should, of course, be included in the financial statements. Whenever practicable inventory by lease or storage area should be maintained on a unit basis, and may be priced at current market less marketing costs for statement purposes or, preferably at average direct lease cost per barrel of crude or MCF of gas produced.

Inventories are also maintained for well equipment parts, and all the various types of tubing, casing and pipe that enter into an oil operation. Such inventories should be priced and controlled in the same manner as is inventory in other industries. An interesting problem arises in connection with withdrawals from stock which are chargeable to outside interests. Generally such items are chargeable to such interests at out-of-stock prices, which may be somewhat more than cost prices. In such instances a realized profit appears in the accounts for the difference between cost and the out-of-stock price for that portion applicable to outside interest owners. Some operators prefer, for purposes of simplicity, to

charge the entire amount at out-of-stock prices and take up the entire profit. In such instances the operator's cost is recovered through periodic depreciation charges and the entire profit appears in income for that year. Under this plan the income statement is somewhat distorted. Better procedure would be to credit the unrealized gain applicable to the producer or operator against the Lease and Well Equipment account. Materiality, in the writer's opinion, governs and controls as to whether or not this latter method is worth the effort involved in determining the facts necessary to its use.

Income

In the first instance separate control accounts should be established for Oil Income and Gas Income. Other accounts may be required as for Distillate Sales, Wet Gas Sales to Recycling or Gasoline plants, or Casing Head Gas sales.

The income account should show the gross income from oil or gas before consideration of gross production taxes. This is a factor, because many operators and producers sell their crude or gas to refining companies or gatherers who pay the gross production tax and present only net interest statements to the producer. In such cases the net interest in terms of money must be worked back to gross interest and entry made in the account as follows:

Dr. Gross Production Taxes (Lease Operating Expense—Direct)

Dr. Cash

Cr. Oil or Gas Income

Detail records of oil or gas income must be maintained, according to lease, in order that net income per lease be determined for purposes of computing statutory depletion.

If the operator or producing company also purchases crude or uses its own production in its refineries, the additional problem of distributing income to interest owners also arises. This is a statistical problem more than a general ledger accounting problem.

If the company operates on an accrual basis it will be necessary to set up an account payable at the end of each month to owners of interest. Generally speaking, the division order applicable to each lease will establish the division of income from that lease. This order may be modified by subsequent happenings, such as oil payment reservations against the working interest or transfer of partial or entire interests in the working interest, fee royalty, or overriding royalties.

The division of income from an oil or gas lease is a very detailed task in most cases, as the property interests are so finely divided. It is not at all unusual to have as many as twenty or thirty participants in the division of such income. The accounting problems are one of detailed record-keeping of the original division of production and subsequent changes thereto. Where the volume is great, tabulating machine methods are ideally suited for handling this problem. Most oil producing companies and operators have this problem to a greater or lesser degree.

It is well to add that, in most instances, the burden of distributing income falls on the purchaser of the crude or gas, although such is not always the case. Likewise, the purchaser acts as the agent of the state in collecting the gross production taxes through the medium of deducting such amounts from balances due for purchases of oil or gas.

In making a remittance to an owner of an interest in an oil or gas lease the following details are usually provided: month and year, interest owner number, lease number, percentage interest, total barrels or MCF gas, total gross production tax, net value—total interest, and net value—interest owner.

Furthermore, it is common practice to supply the operator with a crude oil statement which will show the following data: lease, date delivery, delivery

ticket number, gravity, price, barrels crude or MCF gas, gross value, total tax, and net value.

This latter statement simply supplements the details supplied with the remittance check and permits checking to company record of deliveries.

From the above statement of net value to interest owner, the information necessary to recording income from oil or gas on the seller's books can be developed, as previously discussed on page 684. It may be observed that an integrated oil company has no realized income until such time as the refined product is finally sold to the commercial user.

In certain instances income accounting is somewhat complicated by the fact that the producer may be carrying other parties until such time as a particular lease or well has been paid for from current production, in accordance with agreed terms. Existence of such agreements demands statistical records which show the payout status of such leases or wells, so that the carried parties' interests may be released to them, on completion of payout, through amendment of division orders.

Expenses of Lease Operation

Accounting for lease operating expenses demands a Lease Operating Expense control account, supported by detail Lease Expense ledgers. The detail ledgers are necessary in order that information may be readily obtained at the year-end for ascertainment of net income per lease operated. Detail Lease Operating Expense ledgers may be broken down into expense classifications as follows:

Lifting Costs: Labor, power, repairs, depreciation charges, and miscellaneous.

Other: Workover costs, general and administrative expense, gross production tax, and miscellaneous.

Lifting costs represent only those direct costs incurred during the year for the purpose of lifting the gas or oil to the well head and lease storage facilities. Other costs represent amounts chargeable to a particular lease on a direct basis, which are not part of the lifting cost but are part of the cost of operating a particular lease.

As in the case of income distribution and lease development costs, partners or associates in the production of oil or gas are to be charged with their shares of lease operating expense. This creates an accounting requirement for methods and techniques which will permit billing out such interests on a monthly basis. It is a common requirement that such billings be supported by copies of vendors' invoices, or other supporting data as to costs incurred. There are many complexities of accounting which may arise in such instances as company personnel, equipment, and materials enter into the computation of charges to outside interest owners, as well as General and Administrative Expense charges. These latter amounts are often established on a flat-sum basis by the lease operating agreement entered into between the partners or associates.

In order that billings to associates or partners may be made, it is necessary to maintain a record of the working interest participants and their respective individual percentages of the total working interest, as such percentages will be the basis on which the monthly costs are charged out to them.

In the general ledger two techniques may be utilized: first, the total lease operating expenses for the month may be charged to the expense account and the outside interest owners portion credited thereto and charged to Accounts Receivable—Outside Interests or, alternatively, total charges may be made to a clearing account for all properties in which outsiders participate with a subsequent entry clearing such balances to Lease Operating Expense and Accounts Receivable—Outside Interests. Either method is acceptable, with the latter method having the

writer's preference as the volume of detail grows. The following is a somewhat simplified illustration of a billing to an outside interest owner.

A TEXAS OIL COMPANY
HOUSTON, TEXAS
Invoice for Joint Operations

To John Jones
Houston, Texas

Charges for the month of June, 1954, in connection with operation of Lamarr Townsite Unit No. 1, Lamarr, Texas:

Your Interest in ⅞ Working Interest .0625

	Total	Your Share
Labor	$100.00	$ 6.25
Pump Motor	300.00	18.75
Supervision	50.00	3.13
Credit, for pump motor—Class C	(75.00)	(4.69)
Well Workover—Parts	90.00	5.63
Totals	$465.00	$29.07

It is desired to point out the need for allocating general and administrative overhead to producing leases. There are certain general and administrative costs which are applicable to production. Such costs should be segregated in the accounts from general and administrative costs applicable to non-producing activities. These costs must be allocated to leases, in order to determine allowable statutory depletion charges on a net income basis.

For practical purposes, such allocation may be accomplished on a statistical basis only, outside of the general ledger accounts. Two bases for allocation are suggested, (1) spread applicable general and administrative expenses over total barrels of production and allocate them to each lease on the basis of barrels produced from that lease or MCF of gas produced, whichever is applicable or (2) a simpler method frequently used by the small operator or producer is to allocate applicable general and administrative expenses on the basis of gross income applicable to each lease relative to the total gross income.

Financial Statements and Management Reports

In conclusion, the writer wishes to set forth some brief comments as to the financial statements and management reports that may be prepared for oil and gas operations.

Statement of Financial Condition

This statement does not vary in principle and content from those of other industries. It may be prepared on a monthly basis, with comparison against prior month or the same month of prior year, as an aid to management in determining its financial position and the course of the business.

Income Statement

The Income Statement should be broken down so as to show oil income and gas income separately, less the operating expenses directly allocable to each. There should then follow other sources of income, after which will be deducted the general and administrative expenses. Finally, there will be the deduction for depreciation and depletion charges.

It is felt desirable to prepare such statements on a monthly basis, with comparisons against the prior months totals to date. If also desired, a monthly comparison may be integrated in this statement.

Summary of Oil Runs

This statement should be prepared on a monthly basis and a year-to-date basis. It should show the name of the purchaser, and the Bbls or MCF run this month compared against the same month of the prior year, priced out at current posted price in the field. The same information should be provided on a year-to-date basis. Many producers require such statements classified according to lease, which will demand individual lease run statements and a summary statement of runs for all leases as described above.

Statement of Producing Property Operating Cost

This particular statement is designed to provide management with comparative statistics as to wells in production, production for current month, daily average barrels of crude, revenue from gas and oil, classified detail as to direct and indirect lifting costs, all of which are to be expressed in terms of barrels of crude, or MCF of gas, dependent upon the nature of production. It is most desirable to show such information on a comparative basis, current month versus same month of prior year, and year to date compared against last year to same date.

The above statements and management reports are not the only ones that may be prepared but they are among the principal ones which may be used by management in controlling its operations.

* * *

The information presented in the foregoing pages of this article has been specifically designed to highlight the major accounting problems involved in accounting for oil and gas from the point of exploration up to production for use in refineries, or sales to purchasers. Much detail has been excluded in order that within the space available for an article of this nature, the reader may have a broad comprehension of what has to be done in order to account properly for this type of operation.

Oil and gas accounting problems may be summarized by stating that familiarity with industry jargon is a first essential; secondly, an understanding of federal income tax requirements must be had; thirdly, the sound principles of partnership or joint venture accounting must be applied; and, finally, sound general financial accounting principles adapted to the peculiarities of the industry must be present.

It is hoped that the reader will have gained, from this article, an understanding of the accounting principles and techniques that must be applied for accounting control of oil and gas exploration, development and production.

But Is It Accounting?

By A. C. LITTLETON, C.P.A.

This paper examines critically two recent adaptations of accounting technology: first, in the methodological development with respect to statistics concerning our national wealth and national income and, second, in the proposal to modify the historical cost data in accounts by applying index-number adjustments thereto.

Accounting in the Public Interest

Although accounting began centuries ago as a system of private records in aid of enterprise managements, its rare capacity for rendering varied services eventually produced accounting in the public interest. This was not merely a reshaping of the list of ledger accounts to produce the fund accounting which has proved so serviceable in untangling the interrelations between revenues, appropriations and disbursements. The public interest was more directly served when in various ways enterprise accounting data came to be open to public scrutiny: enforced publicity of financial statements (as by the British Companies Acts); critical scrutiny of company financial disclosures (as by the American Securities and Exchange Commission); by means of voluntary wide publication and distribution of company annual reports to attract funds and report to a large number of people holding corporation securities.

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Various proposals have been made for accounting in the public interest. Some of the ramifications of these deserve to be examined. They may have been conceived in the public interest, but sometimes a question might be raised whether they are accounting.

I—Social Accounting

One of the doctrines of government function prevalent during the 1930's was that the strength of the Federal government should be used to bring the nation out of the depth of economic depression. The strength of government was not only that associated with the ability to pass laws, levy taxes, appropriate funds, change the monetary base, etc., but lay also in the ability of officials to stimulate men to conceive of ideas for vesting additional authority in the central government to direct the nation's activities of production, consumption, and finance along lines considered to be in the public interest. Policy decisions of great significance had to be made almost day by day. The centralization of making decisions gave important emphasis to the factual bases available for consideration. A good deal of use naturally was made of nationwide statistics, since many decisions were to be nationwide in effect.

Impact of National Income Statistics Upon Decisions and Policies Affecting the Public Interest

Economic statisticians had for years been interested in data of national

wealth and national income. Such data now assumed new importance. Their known defects, such as incompleteness of original sources, lack of uniformity in methods of reporting original data, need for better integration of data under analysis, etc., were cause for more than ordinary concern. Improvements and reforms of data, wider use and wider understanding of statistics became an outstanding objective.

This movement has a relationship with accounting evolution since much of the most important data of national income originated directly in the accounts of business enterprises and indirectly from the daily economic activities of the people as a whole. Since statistics of national income, among other data, would be helpful to decisions and policies entered upon in the public interest, the accounting data that entered into such statistics could be viewed as data effected with a public interest. This is quite a modern extension of the significance of accounting, and apparently is without earlier parallel.

Growth of Social Accounting

A good deal of statistical material relevant to national income was already available, but for most effective use in aid of policy-making it needed to be better integrated. Out of this need came the methodological development called "social accounting." In essence the method involved establishing sub-groups of economic statistics which could produce interrelated sub-totals and intermediate summaries designed to make the great mass of data more comprehensible. This objective is clearly the same statistical objective that has prevailed in double-entry bookkeeping from its beginning to the present. Masses of factual data, wherever an understanding of their message is important, must be simplified by classification and compression. In this respect there is a similarity between aggregates of statistics of national income and wealth on the one hand and aggregates of transaction data concerning the wealth and income of a business enterprise on the other.

However, it does not follow that the two systems of classifying and integrating data for these two very different uses can both be appropriately said to produce "double-entry records." Over-all objectives of arranging data into understandable form are not enough to make the two methods sufficiently identical as to justify describing them by the same phrase.

Evaluation of Social Accounting

The methodology of "social accounting," or of almost any other large segment of statistical data, can be arranged into sub-sections and can make use of duplicate entries in a manner which will produce a summary of results showing equal grand totals. In a purely literal sense the entries have been "double"; hence, the summary totals are bound to be equal, also in a purely literal sense. Yet these equal totals can no more be given an informative, descriptive name than can the totals of a trial balance from the accounts of a commercial enterprise.

A more significant fact, however, is overlooked in reasoning by analogy from enterprise "double entry" bookkeeping to social accounts: the analogy is not persuasive because the "doubleness" of commercial accounting is not the essence of that technology. The trial balance has never been more than an inadequate testing in summary of duality in detail of the debit (left) and credit (right) aspect written into each entry in the basic records. And the duality within each entry was only an accidental result of an early perception of the fact that a significant relation existed between real accounts (expressing wealth) and nominal accounts (expressing expense efforts made to produce revenue from enterprise performance). Enterprise management is vitally concerned to have knowledge of the cost of relevant efforts made and of the associated

revenue results accomplished by those effort-costs—almost a cause-and-effect relationship.

Two points of dissimilarity between social accounting and business accounting are here discernible. (1) There is no counterpart in our national economy to management in enterprise operation. (Or is such repudiation of "a managed economy" to be considered treason?) (2) National wealth and national income are not integrated in the way capital at work in an enterprise is integrated with enterprise income as the fruit of effort. One reason the integration is different lies in the fact that national well-being is not satisfactorily measured by aggregate national income, and national wealth is not assembled or used exclusively in producing national income. In a business enterprise, wealth is like a cultivated fruit tree; it is dedicated to the production of fruit. The fruit may be consumed, sold or "reinvested" as seed for future production capital. This is not the picture of the nation's circle of existence. Preservation of our way of life could be vastly more important to national welfare than maintainance of a high standard of living, that is, a high net income for the whole nation derived from a centrally managed national economy.

Need for More Appropriate Terminology

Since the analogy is so imperfect, the phrase "double-entry social accounts" is misleading. It seems to try to draw prestige from the long use and versatile adaptability of accounting technology without approaching the latter's logical foundation. It is perhaps evidence of recognition of the wide service rendered by accountancy, and of a growing desire to extend that service further in the public interest. But accoutancy is not statistics, though it follows the statistical objective of truthful classification. And it would be reasonable to believe that statistics is not accountancy. The limitations inherent in the latter would be a handicap to the services statistics can render as statistics. In a similar way, the flexibility of statistical methodology, if incorporated into accounting as accounting, would constitute a handicap in rendering the accountancy type of service.

Statistical analyses, such as have been called "social accounting," are indeed material prepared in the public interest; and properly used they can serve the public interest even when strongly centralized government control over economic activities does not prevail. But it would seem wiser to use other terminology to headline the methodology, since accounting has been evolving for a very long time into a technology that is necessarily different in most respects from statistics in techniques and service functions.

Adaptation of Financial Accounting Techniques to Governmental Operations

It must be added, however, that criticisms relative to a title such as "social accounting" for a purely statistical operation, do not attach to the adaptation of business accounting ideas and procedures to use within governmental divisions. Since business operation has clearly derived increasing aid over many generations from the use of accounting technology, it must be reasonable to believe that operation of the federal government — the largest operating enterprise in the nation — could be aided if business accounting could be suitably adapted to this service. The need for adaptation rather than outright adoption is clear from the fact that measurement of money profit is not involved there, but is an essential aspect of accounting service to business enterprises. Another way of putting the point is to note that, since profit is not available in government divisions as a sign of effective accomplishment, the other features of business accounting, for that reason, are even more necessary in govern-

mental operations. The other features of accounting of particular usefulness in this setting include well-designed and effectively-used record procedures, planned control over costs and expenses, integration of budget and data from past operating experience, use of internal check, and interval audit.

Growth of the Controllership Function in the Business Activities of Government

One of the most promising recent tendencies in operating the Federal government has been an energetic movement in the direction of incorporating business accounting methods into the operation of many government divisions. Controllers, in the accounting sense of technical assistants in business management, are being installed in many spots and given appropriate responsibilities. Surely all this is highly desirable in government—the nation's most extensive business operation. In fact, it deserves clear characterization as accounting in the public interest. Perhaps it may also be significant that this development is being implemented by accounting-trained men and that it has not been labeled "social accounting" or any other headlining phrase. No doubt it is considered by those concerned as just accounting, or at most as an illustration of the adaptability of accounting technology. It might also be said that this new use of accounting carries implications of some limitations inherent in that technology. There are so many similarities between a business enterprise and an operating division of government, even though the profit motive is lacking in the one, that the accounting methods of one can be employed by the other without doing violence to the ideology and schematic operations of that technology. This is the reason that the use of accounting can be extended in this manner and be "in the public interest."

II—Stabilized Accounting

Another activity affecting accounting is currently undergoing analytical debate and is favored by its advocates partly on the ground that adoption of its ideas into accounting would be in the public interest. The proposal to modify the historical cost data in accounts by applying index-number adjustments thereto, in effect poses another test to the adaptability of double-entry technology.

Index-Number Adjustments of Historical Cost Data

The new proposals seem to have been generated primarily (1) by the persistent rise in price levels for a longer stretch of years than has previously been characteristic of our economy, and (2) by an expressed belief that the possible adverse effects of this continuing economic phenomenon may not be realized by enough people to change the trend or to be prepared for eventualities.

The facts of the trend are unmistakable; and the example of excessive price inflation abroad some years ago is indeed disturbing if a similar outcome is considered possible in the United States. It is obviously advisable for businessmen to give careful consideration in making their business decisions to the significance at the moment and for the near future of price-level trends. They should be alerted by all suitable means to the fact that "money" profits are, because of rising prices, not identical with "real" profits.

In the same direction the people generally should be constantly reminded that money wages are not real wages unless the purchasing power of the paycheck is relatively stable. No doubt, most workers have reason to be pleased with the present relation of wages they earn and the cost of living they pay. Perhaps business men similarly feel confident of the future. Both parties may be right as to the essential features of the future of this country. Yet both may not benefit from this

attitude as expected; mistaken policies in their private and business planning during the present may stand in the way.

Perhaps it is this line of reasoning that leads some forward thinkers, economists and economic statisticians particularly, to advocate use of various ways and means of alerting business management, government policy makers, and the producing and consuming public to conditions shaping present economic trends and to possible undesirable consequences of unchecked speed and direction of change.

Yet some of the suggestions of methods, especially those for alerting businessmen to the need for carefully viewing the future while planning in the present, may well be questioned inasmuch as they could involve, if fully implemented, a very serious modification of the very characteristics of today's business accounting which have long been rendering highly effective aid to managerial and investment decisions. Because the well-being of the economy would be gravely affected by a long-continued and rapid price inflation, the proposal for the use of index-number series to translate the familiar historical costs of accounts into current-price equivalents may seem to promise a further extension of "accounting in the public interest."

Inflationary Effect of Rising Price Levels

The chief charge of "distortion" made against historical costs, especially costs expressed by depreciation expense, is that the established accounting processes fail to eliminate the inflationary effect of rising price levels from the net results of the income statement calculation. The theory seems to be that use of statistical procedures (clearing of price effects) would eliminate this "distortion" in the income calculation and thus prove to be "in the public interest." It is a fact that the public interest would benefit from a dampening of the trend for prices to rise. But there is little or no basis for drawing a defensible conclusion that the proposed direct modification of accounting procedures would contribute materially to the needed modification of price-level change.

Will the Use of Replacement Costs Improve the Quality of Business Judgments?

Those who are convinced that most businessmen throughout a long past have quite successfully made business decisions in the presence of a reasonably realistic judgment of probable future conditions, will find it difficult to believe that the proposed "reform" of established accounting thought and practice is necessary to keep business men making good judgments of the near future. It is reasonable to believe that about as many may be confused into poor planning by lack of historical costs reflecting past decisions as are likely to be brought to wiser decisions by ignoring historical costs (and past actions) in favor of their substitute "current-price equivalents." After all, these "equivalents" are only the resultant of statistical assumptions and processes that are a greater mystery to more people than are the technicalities of accountancy. Moreover, "current price" is a useful guide to decisions affecting the enterprise in the future, only to the extent that future prices are similar or correctly diagnosed as trending higher or lower. There can be little doubt that many unfortunate decisions have arisen from incorrect assumptions that current conditions will continue forward, whereas presently the conditions moved very differently.

It seems too much to expect that index numbers applied to accounting operations could nationally improve businessmen's faculty for correctly previewing future trends. If he still has to make this effort by using other means, it would seem that solving his most difficult problem would not be helped by modification of his accounts. Therefore, a question arises as to how

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Composite Depreciation Under the Sum-of-the-Years'-Digits Method

By Jacob Heskes, C.P.A.

This paper outlines and illustrates the manner in which the composite method of calculating depreciation may be applied under the sum-of-the-years'-digits method.

The sum-of-the-years'-digits method of depreciation requires the maintenance of subsidiary fixed asset records, if completely accurate monthly computations are to be obtained. However, where the only requirement is an accurate annual computation, and a pro-rata monthly figure (1/12 of the annual amount) is acceptable, the need for maintaining these detailed subsidiary records may be obviated by grouping all fixed assets of equal length of life according to year of acquisition, and applying a composite depreciation rate to the group. All the information required may easily be accumulated in the year-end working papers.

Basis for Suggested Composite Depreciation Method

The following mathematical characteristics of the sum-of-the-years'-digits method form the basis for the suggested composite depreciation method:

1. Where an asset is acquired *during* the taxable year, the depreciation rate for the following taxable year (the first full taxable year of depreciation) is a combination of the respective pro-rata portions of the first- and second-year depreciation fractions. For example, consider an asset with a five-year life, acquired on April 1 by a calendar-year taxpayer. The depreciation rate for the next *following* taxable year is 3/12 of 5/15 plus 9/12 of 4/15, or 4.25/15. It will be observed that the decimal portion (.25) of the numerator of the fraction expressing the depreciation rate is the fractional part of the taxable year *preceding* the anniversary of the date of acquisition. The entire numerator of the fraction (4.25) represents the years of remaining useful life of the asset at the beginning of the taxable year.

2. Regardless of the date of acquisition of the asset, the numerator of the fraction representing the rate of depreciation is reduced by 1 each succeeding taxable year, reflecting the corresponding reduction in its remaining useful life. Thus, in the case of the above asset, the depreciation rates for the third and succeeding taxable years are 3.25/15, 2.25/15, 1.25/15, and .25/15.

3. The foregoing principles may be expanded to apply to a group of similar assets acquired in the same year by computing the first taxable year's depreciation for each asset in the group, totalling these, dividing the total by a full initial year's depreciation for the group, and thus obtaining a decimal representing the portion of the first year *following* the composite date of acquisition. To ascertain the decimal portion of the numerator of the fraction expressing the depreciation rate in subsequent years, subtract the foregoing decimal from 1.

Illustrative Example

The following is an example of the operation of the composite method on a group of assets having a five-year life:

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Composite Depreciation Under the Sum-of-the-Years'-Digits Method

Date Acquired	Cost	Depreciation Fraction	Calendar Year 1954 Depreciation
1-1-54	$ 750.00	12/12 of 5/15	$250.00
4-1-54	1,000.00	9/12 of 5/15	250.00
8-1-54	500.00	5/12 of 5/15	69.44
12-1-54	300.00	1/12 of 5/15	8.33
	$2,550.00		$577.77

A full initial year's depreciation for the group is 5/15 of $2,550.00, or $850.00. The fractional part of the taxable year following the composite date of acquisition is $577.77/$850.00 or .6797. The decimal portion of the numerator for succeeding taxable years is, therefore, 1 minus .6797 or .3203.

The accumulated depreciation in this case would be computed as follows:

Year	Depreciation Fraction	Addition to Accumulated Depreciation
1954	(Detailed computation)	$ 577.77
1955	4.3203/15	734.45
1956	3.3203/15	564.45
1957	2.3203/15	394.45
1958	1.3203/15	224.45
1959	.3203/15	54.43*
		$2,550.00

* Includes adjustment of $.02.

When an asset included in the composite group is sold, it is necessary to recalculate the decimal portion of the numerator for the remaining life of the other assets, as follows:

Assume that, in the example above, the asset acquired April 1, 1954, was sold on September 1, 1957. The final taxable year's depreciation and the total accumulated depreciation for the asset sold must be determined exactly. The following calculation must then be made:

	(1) Cost	(2) Decimal Portion of Numerator	Product (1) X (2)
Total assets in group	$2,550.00	.3203	$816.77
Less: asset eliminated	1,000.00	.2500*	250.00
Balance	$1,550.00		$566.77

* Determined by reference to the April 1 acquisition date.

$566.77/$1,550.00 is .3657. The new decimal portion of the numerator is .3657 and is used for the year of sale and succeeding years with respect to the remaining assets.

The following is the accumulated depreciation schedule in this case:

Year	Depreciation Computation	Reductions	Additions	Accumulated Depreciation
1954	(Per detailed computation above)	$ —	$577.77	$ 577.77
1955	4.3203/15 of $2,550.00 = ...		734.45	1,312.22
1956	3.3203/15 of $2,550.00 = ...		564.45	1,876.67
1957	Final depreciation on asset sold, to date of sale:			
	(3/12 of 3/15 of $1,000.00) + (5/12 of 2/15 of $1,000.00) =		105.56	1,982.23
	Accumulated depreciation on asset sold:			
	$\frac{5+4+3+(5/12 \text{ of } 2)}{15}$ of $1,000.00 =	855.56		1,126.67
	Annual depreciation on assets remaining unsold:			
	2.3657/15 of $1,550.00 = ...		244.45	1,371.12
1958	1.3657/15 of $1,550.00 = ...		141.12	1,512.24
1959	.3657/15 of $1,550.00 = ...		37.76*	1,550.00

* Includes adjustment of $.03.

In order to provide the minimum information required for the composite method the year-end working papers should include a complete analysis of the fixed assets acquired during the year and their corresponding depreciation accumulations. Assets acquired in previous years need only be listed in total, by year of acquisition. A record should be kept of the decimal portion of the numerator of the fraction pertaining to each such previous acquisition year.

But Is It Accounting?

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effectively this modification could extend the capacity of accounting to serve the public interest.

Coordinated Use of Services of Economists and Accountants by Government

The Federal government and some of the larger business enterprises employ trained economists to analyze and undertake to interpret economic trends, as well as accountants to analyze and interpret enterprise facts resulting from prior managerial decisions. Perhaps it would be a more constructive suggestion to advocate rapid expansion of the use of economists within enterprises, either as employees or as regular consultants. At least such a development would avoid the emasculation of managerial accounting in the attempt to bring the impact of economic conditions to management's attention. Management could then have the benefit of expert staff assistance on both sides. Making decisions is an executive function; it is a difficult art at best, and at worst mere hopeful guessing. It is reasonable to believe, therefore, that better aid to decisions would emerge from a separation rather than a merging of the two best "intelligence services" available to enterprise managers. Through aid to better enterprise management such a development would indeed be in the public interest.

A Case Study in Cost and Expense Reduction for a Large Electrical Equipment Manufacturer

By JAMES P. MCCULLY

One of the ways of maintaining the level of dollar profits in times of rising production costs is to institute an effective program of cost and expense control and reduction. This paper tells how this is being done by a large-scale manufacturing organization.

The Corporation

The Corporation, which is primarily an operating company, has been in business for more than sixty-five years and is engaged in the manufacture and sale of apparatus and appliances which generate, transmit, utilize and control electricity. The industry is highly competitive.

The 8,000 basic products which the Corporation produces include practically all electrical and related mechanical equipment required by electrical power companies, railroads, city transit systems, industrial plants, the Navy, marine industry, and certain equipment for the aviation industry. Some of these products, such as motors and control devices, are sold to other manufacturers for application to their products, such as machine tools, washing machines, pumps and other electric-powered equipment. Electrical equipment is supplied for the mining, drilling and recovery of coal, ores, oil and other extractive industries. Other products are used on farms and on farm implements. In addition, the company produces a variety of consumer products.

The Corporation's net sales for 1952 were approximately 40% of the industry's total of about five billion dollars. During 1952, the Corporation paid approximately one-half billion dollars in salaries and wages to its employees in 87 plants situated in 31 States. In addition, the firm operates several radio and television stations.

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This paper was awarded First Prize in the Society's 1954 Prize Essay Contest.

Basic Cost and Expense Reduction Programs

Basically, the Cost and Expense Reduction Programs consist of: (a) Cost Reduction; (b) Expense Reduction; and (c) the Productivity Improvement Program together with the Nonstandard Hour Reduction. Actually, these main categories for classifying savings are inclusive of everything that is done to reduce cost and increase profits. However, supplemental projects to augment the above programs are as follows: (a) the Expense Personnel Programs; (b) the Paper Work Savings Program; (c) Manufacturing Operating Statistics Chart

Book; and (d) Summary of Budget Statements.

At the operating division level, programs are carried out through the combined efforts of a Cost Improvement Policy Committee, Cost Improvement Supervisor, Foremen, Managers of Office and Service Departments, the Budget Administrator, Shop and Engineering Committees consisting of Design Engineers, Time and Motion Analyists, and Manufacturing Engineers.

The effectiveness of the savings made possible through the operation of these formal programs is measured in relation to net sales billed, sales value of production, and the relationship of overhead or expense to productive personnel. On an overall corporate basis, one division is compared with another, wherever operating conditions are similar.

Cost and expense reduction programs are expected to have an operating meaning which will be real and which will disclose the factual results applicable to the current year. These programs are established to help the divisions of the organization become and remain efficient. The Corporation, through its local divisions, uses the programs to determine means and methods of offsetting added costs such as increased wages, increased material prices, premiums, and sales price softening. By the use of these programs an attempt is made to compensate in full for the added costs so that it is not necessary to increase sales prices to carry part of the load for increased cost because an eventual saturation point is reached where sales price increases cannot be expected to do this job.

This review will attempt to reflect the viewpoint of big business toward its efficiency and money saving programs which are integrated into formal, well-defined efforts toward increasing the profit ratio, or at least maintaining that ratio in the face of increased operating expenses.

Cost Reduction Program

An effective cost reduction program provides the means for analyzing studying and applying new methods processes, equipment, tools and materials to existing product designs, processes, and methods to improve the product or its cost. It can be applied to any and all products because new machine tools and equipment, new processes, and new materials are constantly being evolved.

Many factors that contribute to cost reductions coupled with potential savings and improvements, cannot be realized unless a systematic and well-defined analysis procedure is established somewhat as follows: (a) Cost reduction organization (Cost Improvement Policy Committee); (b) a definite program established through the review of design, manufacturing, methods and financial aspects of the product to determine what parts, components or products need analysis and cost reduction effort; and (c), determination of systematic procedures and approach to be followed by the Cost Improvement Supervisor who provides consulting service for all departments and individuals who contribute to the program.

Cost reductions apply to direct cost savings on product and reflect changes in processes, methods, design specifications and the procurement of material applicable to changes regardless of how financed. Also included is the improvement in labor classifications properly documented, if applicable to direct cost.

Inventory control, economical production in quantities, sound purchasing policies, and analysis of clerical functions, also provide means for developing and maintaining efficient operations.

Cost Reduction Organization

The cost improvement policy committee consists of: (a) Engineering Manager—Chairman; (b) Manager of Manufacturing; (c) Industrial En-

gineer; (d) Purchasing Agent; (e) Manager of Accounting; (f) Budget Administrator; and (g), Cost Improvement Supervisor — Engineering Department.

The principal function of the Policy Committee is to stimulate and encourage cooperation of all departments in the division to attain the established cost improvement goals. In addition, the Policy Committee informs executive management of the monthly progress reported, estimated savings, and all open projects for product improvements. The Committee also receives monthly reports covering cost improvement reports prior to their transmission to headquarters.

The Policy Committee considers the following aspects of cost and expense reduction: (a) Engineering — design, development, performance in service, field repair charges, appearance; (b) Manufacturing—plant layout, replacement of tools and equipment, adequate facilities, delivery, quality; (c) Industrial Engineering — time values and work measurement; (d) Purchasing—inventory, supplies; (e) Accounting and Budget Administration — costs, profits, investments, size of markets; and (f) Cost Improvement Supervision—organize, analyze, plan and administer details to adequately carry out cost improvement program.

The following departments and individuals whose duties are reviewed below, together with the Cost Improvement Supervisor, have the major responsibility for making the cost reduction program function effectively: (a) the Design Engineer is responsible for the proper performance of the product, as well as approving all changes in product design and specifications before they are put into effect; (b) the tool Supervisor is responsible for tool design, toolmaking, and procurement of machine tools and equipment; (c) the Industrial Engineer, who is responsible for the time study and methods department, is continually concerned with cost reduction and methods improvement; (d) the General Foreman is responsible for making operation changes work in his department in the most economical manner; (e) the cost Representative compiles detailed cost information, estimates, and analysis for proposed improvements; (f) the Manufacturing Engineer has the technical knowledge and experience to coordinate the activities of the above groups in regard to individual cost reduction projects; and (g), in addition, the departments of quality control, purchasing, production planning and scheduling, and inventory control are available for consultation on specific projects.

The above personnel and departments will vary with the individual cost or expense reduction project, and with the shop section and product. Where there are numerous projects in operation at one time, some personnel are common to all projects, while others will be identified with only one or a few projects. Although the Cost Improvement Policy Committee meets only about once a month, personnel working on the various cost and expense reduction projects hold analysis and work meetings at frequent intervals to integrate details necessary to successfully complete assignments.

The Cost Improvement Supervisor of the Engineering Department is the focal point for all cost improvement activities. He has an adequate staff of engineers and sufficient supporting help to assist all departments in carrying out the cost improvement program on all lines of apparatus. He is responsible for planning and administering the overall program while the major function of his group is to maintain cooperation on cost improvement projects by providing helpful service to all departments involved in the problem.

The Cost Improvement Supervisor cooperates with the Policy Committee in establishing an annual goal for the division. A periodic review of the

actual progress against the predetermined goal is made so that revision of the estimated reductions can be made if the situation changes. The Cost Improvement Group cooperates in establishing the various departmental goals and maintains records to show the results attained. When a cost improvement idea is rejected, the individual submitting it is advised in person and by letter as to the reason for the rejection.

Cost Reduction Procedures

All cost improvement proposals are submitted to the Cost Improvement Supervisor, who initiates investigation and action, as necessary, to follow the project. Where appropriate, projects are entered in the Planning Procedure (if tooling, machinery, and fixtures are involved). Notation of planning is assigned in the minutes of these projects. All cost reduction projects are assigned a number, which is coded as to month of origin and apparatus line.

Suggestions, submitted by individual employees, are sent to the department concerned and, if accepted, entered into the regular cost reduction procedure.

Purchasing Department savings in material cost not included in cost reduction programs, such as source of supply or renegotiation with a source of supply, are shown on monthly reports as separate items against a specific Purchasing Department goal.

The cost and expense reduction program requires general as well as technical working knowledge of the following subjects: (a) product design engineering; (b) material and process engineering; (c) chemical and physical property analysis; (d) tool and equipment application; (e) manufacturing engineering; (f) plant layout and materials handling methods; (g) machine layout and operation; (h) manufacturing operation analysis together with process charts; (i) economical manufacturing quantities; (j) time and motion study, (k) work simplification; (l) clerical function analysis; (m) inventory and purchasing controls; (n) budgeting control of operating expense; and (o), cost analysis.

Savings are based on direct labor and direct material costs. Works delivery cost may be indicated. Standard labor and overhead rates are on an up-to-date basis, even though such rates may not currently be used for charging and crediting inventories. Latest material prices, inclusive of premium, are used regardless of the standard prices recorded in current inventories.

Contemplated savings are based on realistic forecasts of quantities to be manufactured. It is deemed advisable to use quantities manufactured rather than quantities sold, as quantities sold are difficult to determine and profit is contingent on market conditions which are outside the control of the cost reduction program.

Where a part formerly made in the plant is now bought outside, the cost reduction is the difference between the works delivery cost of the manufactured part and the standard cost of the purchased part. This is reported as a material saving.

The effective date is determined by the Cost Reduction Committee in conjunction with the Cost Improvement Supervisor and the Manager of Accounting. Before cost reduction projects become effective, inventories on hand should be depleted if at all feasible. Since, in the final analysis, surplus and obsolete inventories are the responsibility of the Production Department, this matter is given consideration by the works member of the Cost Reduction Committee. Obviously, new labor values have to be in effect and new materials available if involved.

Cost reduction dockets which are believed to have universal interest are forwarded by individual divisions to manufacturing headquarters for review. These dockets selected for distribution to other divisions are returned to the originating divisions

where additional written material is developed, describing the application; tools or equipment required; procedures, materials or processes used; design changes required; names and addresses of suppliers when items bought outside are required; necessary descriptive photographs, and any additional information required by other divisions to accomplish similar cost or expense reductions. The information obtained from the originating division is then put into printed circulars for distribution to other divisional Cost Improvement Policy Committees or Coordinators. After the supervisory personnel in the divisions have had an opportunity to determine possible applications of the circular subject in their particular areas of supervision, the normal procedure of entering and completing cost or expense reduction dockets is followed if the material contained in the circular becomes the basis for developing an additional docket.

Benefits of these procedures are: (a) the number of new costs or expense reduction dockets entered is materially increased with a resultant increase in reported annual savings; (b) since a proven method, process, or design used by one division to accomplish cost or expense savings is made available to other divisions, the time and expense of developing a similar method, process, or design for use in another division is eliminated or reduced, thereby making it possible to obtain realized savings in a much shorter time than is ordinarily possible; and (c), when names and places are incorporated in the descriptive material, greater participation by supervisory personnel in the overall cost reduction program is obtained so that progress in reducing cost is accelerated.

Reclassification of Incentive Labor Grades

Reclassification of incentive jobs deals with productive hourly reclassification and segregation of lesser skills from a given job, so that it is possible to set up a lower classification by work simplification. In addition, this part of the Productivity Improvement Program deals with properly classifying present labor grades which may have been over-classified through error.

The annual hourly reclassification goal, which is the responsibility of the Industrial Engineering Department, includes the effect on classifications due to: (a) hires; (b) terminations—other than for economy — economy terminations are not a part of the annual reclassifications goal; (c) reclassifications; (d) merit increases; and (e), downgrading.

In addition, the annual goal includes: (a) simplification of old and new operations so as to require lower class of labor; (b) breakdown of jobs to permit use of helpers or lesser skills; and (c), distribution of personnel in labor grades.

Time value changes because of methods, designs, or tool revisions resulting in labor grade changes are included as reclassifications.

Productivity Improvement—Reduction In Non-standard Hours

Non-standard Hour Reduction, which is a part of the Productivity Improvement Program, is an attempt to reduce the number of hours allowed, in addition to the standard time value hours, for a particular operation because of conditions not foreseen and therefore not included in the time value allowed; in other words, hours allowed for extra set-ups, non-standard manufacturing conditions — such as, poor tooling, re-routed work, waiting for material, lost time due to defective tools, lost time due to substitution of material, non-standard conditions due to engineering changes in product design, and non-standard conditions due to manufacturing of expense material or services.

In the administration of wage payment to incentive workers, manufacturing operations may be performed

under standard or non-standard conditions.

An operation is considered as being performed under standard conditions when it meets all the following requirements: (a) it is authorized by a pay document issued by the Manufacturing Information Department; (b) the standard labor value for established conditions is shown on the pay document; and (c), the operation is performed under the established conditions and total time reported as shown on the pay document.

Operations performed under conditions other than these outlined above are considered as being performed under non-standard conditions.

Pay documents, authorizing all work and time for non-standard conditions, are originated by the Foreman, or his authorized management representative, and are issued prior to the starting of the operation or as soon as the condition is noted.

The program proves a tool for effective reduction in the payment of hours for non-standard conditions as well as focusing attention on their existence so that measures can be instituted to remove or reduce the underlying causes which result in requests for payments under non-standard circumstances. The Industrial Engineer establishes trend measurements for the division. In addition, he establishes annual bogeys and reports monthly achievements against these bogeys on the basis of the Accounting Department report, "Summary of Incentive and Non-Incentive Hours and Analysis of Non-Standard Allowances." The Industrial Engineer also develops and maintains charts of non-standard conditions for use by the General and Line Foreman in the control and development of programs for action to correct unsatisfactory conditions.

Productivity Improvement— Reduction in Other Direct Costs

In general, this part of the program has proven to be an effective means of arresting the gradual trend of higher incentive efficiency payments. Critical analysis is made of: (a) hours allowed for set-up operations; (b) hours allowed for instruction and learning time of new and re-assigned employees; and (c), day-work hours of incentive employees, payment for which is made at special or average earned rates.

The program is designed to provide the means for eliminating payment of hours for duplicate and partial set-ups that are not required to be performed, eliminate payment of hours for instruction and learning time for new or re-assigned employees that is not in compliance with their real efficiency, avoid payment of special or average earned rates for day-work hours of incentive employees, making certain their regular productive work for which no time values have been established is paid for at established day-work rates.

The hours in question are an inherent part of the Wage Incentive System. They are used where sound and practical wage incentive administration dictates and, therefore, cannot be reduced below what sound practices require. Segregating these hours and instituting controls over them tends to direct a substantial number of them into productive channels. The control of these three classes of hours rests directly with shop supervision, together with the Industrial Engineering Department which is interested in the effect on incentive percentages. A lack of proper control of these hours on the part of line supervision can have a detrimental effect on the best efforts of the Time Study Department to provide time values that are commensurate with sound wage incentive administration.

Expense Reduction Program

Expense reductions apply to reduction in factory, engineering, sales, administration, and all other budgets classified as expense. The program includes reductions in hourly expense labor, salary, reductions in materials

resulting from curtailment in their use, and changes in specifications. These reductions may result from mechanizing office methods, change in methods or procedures for doing routine office work, conveyorizing material handling, improvements in labor classifications, increased productivity, and correction of excessive help.

Expense Reduction Organization

The Cost Improvement Policy Committee, in addition to providing effective guidance to the cost reduction program, stimulates and encourages cooperation of all departments in establishing a systematic and well-defined expense reduction program. Most of the principles applicable to cost reduction apply equally well to expense reduction in the overall money savings program. In fact, many improvement ideas involve combined expense and cost savings which are segregated for record purposes only.

Departmental and individual responsibility for expense reduction projects are coordinated by the Cost Improvement Supervisor, who provides helpful service to all departments involved in a project. As with cost reductions, all expense improvement proposals are submitted by the originator to the Cost Improvement Supervisor. He in turn initiates investigation and action as necessary to follow-up the project. All expense reductions are assigned a number which is coded as to month of origin and apparatus line.

Expense Reduction Procedures

General and technical working knowledge of tool and equipment application, manufacturing engineering, plant layout, materials handling methods, work simplification, cost analysis and other working tools of cost reduction are also applicable to expense reduction projects. The basis for calculating and reporting is similar to those reviewed for cost reduction dockets.

Paper Work Savings

Paper work savings are part of the Productivity Improvement Program and include plans for simplification of procedures and the reduction of paper work. It is necessary to take steps to continually re-vitalize the paper work system by stimulating and promoting projects which deal with savings by simplification, decrease and elimination of office routines.

Expense Personnel Program

The Expense Personnel Program is used as a basis for comparing the present ratios of expense personnel to productive employees with that of its base period "best" ratio as well as with other divisions which have similar operating conditions. This ratio also emphasizes the particular area where individual divisions can concentrate on the reduction of expense employees by: (a) determining if the job and/or employee is essential; and (b), analyzing work to determine if it can be simplified and combined to reduce personnel.

Supplemental Projects

Salary Reclassification

The Productivity Improvement Program also provides for the review of salary and hourly expense classifications to determine if they are correct and whether any basic skills can be taken out of a given job and segregated into lower classifications.

The following are considered in establishing the annual salary reclassification goal: (a) analyze duties required, and separate items involving lesser skills so they may be assigned to a lower coded employee, or develop lower codes; (b) limit increases to merit, using target points; (c) limit merit increases to those which can be financed by turnover, i. e., by deaths, quits, and retirements with replacements at lower level; and (d), establish goals for distribution of personnel in the various codes.

The annual goal also includes: (a) simplification of procedure, (1) analyze work being done and eliminate unnecessary records and reports, (2) improve current methods used in clerical tasks; (b) machine replacement of clerical work; (c) reduction in cost of supervision, (1) reduce number of foremen per employee, (2) streamline organization; and (d), consolidation of jobs.

Summary of Budget Statements

A Division Summary of Budget Statements, prepared on a monthly and period basis, summarizes the actual expense, the budget allowance, percentage of variance from budget, and the number of employees for each shop and departmental budget of the division, so that local management has a quick view of the above data on one statement. When detailed statistics are necessary, they are available for review from the respective detailed factory and departmental budget statements.

Manufacturing and Operating Statistics Chart Book

The Manufacturing and Operating Statistics Chart Book has been used to develop factual statistics on a comparable basis for each division covering the years 1939, 1940, 1948 through 1953, and currently by months. The charts give division and headquarters management a quick source of information covering the above period of years concerning the number of productive employees, hourly expense, salary expense, factory cost, factory expense, selling expense, engineering expense, headquarters charges, premium overtime, orders entered, unfilled orders, inventory, net sales billed, sales value of production, dollars of operating profit and percentage of operating profit.

The charts enable the local Division Manager to locate the overall factors affecting the division's operation, particularly if objectives have been instituted. In addition, the charts enable headquarters management to review the divisions' operations and make comparison with established objectives and with other divisions which have similar operating conditions.

Monthly and Annual Reports

Monthly and annual reports of cost and expense reduction accomplishments are reported to headquarters for incorporation in the company monthly and annual reports.

Comparison with Programs of Other Manufacturers

Many of the small and medium-sized manufacturing organizations[1] contacted for information relative to control of expense and cost reduction programs stated that they have no formal programs. Consequently, many of them have no written procedure, but are aware of existing inefficiencies and constantly analyze and discuss them with the proper personnel in their organizations in an informal manner.

Other manufacturers replied that cost and expense reduction programs are written up in numerous forms and not necessarily collected together in one spot in the form of a manual. Therefore, it was impractical to transmit a complete outline in written form.

An executive in the manufacturing and distribution field felt that programs for control of costs and expenses were definite management problems which cannot be rigidly controlled by formal programs. He believes that management must rely on reports from its accounting and statistical departments for the information necessary to control costs.

A corporation, whose principal business is processing lumber, utilizes an Industrial Engineering Department to

[1] Twenty-four corporations with annual sales volume between $30,000,000 and $60,000,000.

detect waste points in its operations, and corrects them through method or product improvement. This department is aided by all departments in the organization on major projects such as mechanized material and product handling, loading, and storage.

Cost and expense reduction programs in larger corporations are usually well-defined and closely tied-in with accounting and budgetary controls. Budget reports are an efficient tool by which management is able to supervise activities by following the principle of "management by exception." Systems of budgetary control depend upon a well-defined account structure which segregates expenses into fixed and variable classifications. Variable expenses are those which are controllable and vary in direct proportion to some selected base, such as direct labor hours, dollars, or shipments. Controllable expenses are those which departmental supervisors or foremen are held directly responsible for controlling. The incentive offered to control these variable expenses is usually tangible, i. e., profit-sharing, incentive compensation, or other profit-distribution schemes. Fixed expenses are not variable by nature and must be absorbed over a period of time, irrespective of volume or output. The fixed, or non-variable expense, represents the managerial policy expense for the cost of maintaining an organization to meet productive needs as determined by current sales objectives.

Wagner[2] lists the following conditions necessary for effective cost reduction activities: (a) a *real desire* in the top authority of the plant to operate as efficiently as possible through an established cost reduction department; (b) accurate cost reports on material, direct labor, indirect labor, and overhead costs presented in an understandable manner; (c) itemized accounting reports of how departmental expense money is spent; and (d), standards—*attainable ones* — not the kind which can only be met when conditions are completely favorable. Most people will fight to reach a reasonable goal but lose interest if it is beyond the possibility of attainment. In summary, Wagner states that a cost reduction department does not reduce costs. This is done by operating personnel, who must be given credit for efforts expended.

In an excellent review of productivity, Langenberg[3] believes that management is interested in productivity on a company level which will place greater emphasis upon methods to increase productivity as a means of remaining competitive. He advances the axiom that either an increase in output (with the same input) or a decrease in the total of the various factors of input (with the same output) results in an increase of productivity. He lists the major input factors as: (a) direct labor hours; (b) indirect labor hours; (c) salary hours; (d) depreciation (equivalent hours); (e) repairs and maintenance (equivalent hours); and (f), material yield (this may be measured separately).

Since a decrease in the ratio of the above factors of input to output is equivalent to an increase in productivity, Langenberg believes the following ways and means can be used to accomplish this: (a) volume; (b) modern facilities; (c) better supervision, (1) yield, (2) machine utilization, (3) salaries, (4) maintenance; and (d) employee participation.

Although good supervision and manufacturing practices will increase productivity to a certain level, potential savings beyond that point are possible through employee participation. Hence

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[2] Wagner, F. W., Jr., Planning Manager, Tube Turns, Inc., Louisville, Ky., in the *N.A.C.A. Bulletin,* July, 1952, Section I, Vol. XXXIII, No. 11, pp. 1303-7.

[3] Langenberg, William, Manager, Cost Div., Johnson & Johnson, New Brunswick, N. J., "Increasing Productivity Through Control Reports," in the *N.A.C.A. Bulletin,* Section I, Vol. XXXIV, No. 8, April, 1953, New York, pp. 782-993.

industrial relations is now an essential tool of management.

In an excellent review of cost reduction Payne states[4] that the moment management relaxes and lets costs alone, they start to get out of line again. Thus, cost reduction is not a one-shot proposition but a continuing process. The time to start an intelligent cost reduction program is now because everything points to sterner competition in the months and years ahead.

In summarizing a well-developed cost reduction program in effect at Monsanto Chemical Company, Garrels states[5] that cost reduction is a management responsibility which requires planning of all phases of a comprehensive program. It is not a sporadic, one-shot proposition which can be done by decree. The organizational structure must clearly define responsibilities and authorities. The accounting system should be clear and understandable, because people want to see some tangible evidence of their accomplishments. Both wage and salary personnel should be brought into the program, and everything should be done to increase their understanding of the reasons behind the need for lowered costs.

Studies of the National Industrial Conference Board, Inc., indicate that the success or failure of a cost reduction program depends more on effective executive leadership than upon any other single factor.[6] However, organization and executive control are only partially effective until every employee has a responsibility for assisting in the curtailment of costs because fulfilling this responsibility is to his individual advantage.

The following summation of an editorial in Modern Industry[7] on prices, productivity, and pay provides a lucid picture of problems facing management and labor today. The editor stated that the National City Bank had just completed an analysis of 3,440 corporate financial statements. The bank discovered that profit margins in manufacturing dropped from 6.2% in 1951 to 5.4% in 1952. For all corporations the return on net worth was the lowest since 1946. Costs are catching up with profits. The editor went on to say that the following problems are inherent in the drive to link wage increases to productivity: (a) the standard measurement of productivity—output per man-hour—does not reflect human labor productivity exclusively; and (b), productivity measurements should include tools, machines, and power, all paid for by the stockholders, because these are mainly responsible for increased productivity, although better training and methods have improved the workers' efficiency. The bank's statistics showed that productivity fluctuates widely from one decade to another. For example, productivity rose 34.5% during the 1920's, 19% during the 1930's, and 20.5% during the 1940's. The editor also pointed out that a study by the Guaranty Trust Company indicates that earnings of factory workers are high in relation to productivity. In 1952, they were 76% above the 1919-41 average; whereas output per man-hour in manufacturing was 54% above. In summary, the editor felt that management must furnish itself and its employees with the facts about productivity increases and their long-term implications. He felt that many of the

[4] Payne, Bruce, "A Program For Cost Reduction," in *Harvard Business Review,* Vol. 31, No. 5, September-October, 1953, pp. 71-82.

[5] Garrels, John C., Jr., Production Manager, Plastics Div., Monsanto Chemical Company, Springfield, Mass., "Developing Cost Awareness," in *American Management Association, Inc.,* Manufacturing Series, No. 202, April, 1952, New York, pp. 3-8.

[6] "Cutting Costs in Industry, I. Factory Costs," Studies in Business Policy, in *National Industrial Conference Board, Inc.,* No. 37, New York, October, 1952, pp. 4-5.

[7] Editorial in *Modern Industry,* Vol. 25, No. 5, May 15, 1953.

workers, as well as many executives, have a blurred concept of the issues.

Conclusions

Over the long run, economic forces tend to narrow the profit margin and raise break-even points caused by: (a) increased costs due to increased costs of material and labor, wage demands, and rise in indirect costs; and (b), by trend of comparative lowered selling prices due to waning markets and consumer resistance to higher prices in a mass production economy.

To maintain dollar profits, business seeks (a) to develop new products and/or new markets; and (b), cut costs and expenses on current production methods and techniques. Of the two possibilities, cutting unessential costs and expense is an important area for continuous investigation if a company is to retain its comparative advantage and position in the industry.

The cost problem in any enterprise has many facets. This is particularly significant in big business where cost and expense reduction programs are necessary to control or reduce "creeping" costs which amount to about 3% of the annual net sales billed. Equivalent cost and expense reductions must be made to maintain or improve the break-even point.

Cost reduction programs are effected by: (a) formal programs, with annual fixed goals, prevalent in the larger organizations primarily because they are so all-inclusive that they require more coordination than one person can possibly provide — it is believed that planned programs pay out in reduced confusion and increased speed of action which produce a better profit position for any company; and (b) informal approaches, which are normal in the smaller firms because the executives tend to identify themselves with these problems due to intimate knowledge or long experience.

Cost reduction programs are usually generated by: (a) top management, which must take a definite interest in the cost reduction programs if they are to have a maximum effect; details can be worked out by qualified subordinates or specialists, and "on the spot" direction delegated to minor executives; and (b) a good incentive plan to keep foremen and supervisors cost-conscious, even through periods of production-at-any-cost and, in addition, to stimulate the involved personnel to do their best when their responsibilities have been clarified and clearly defined.

Cost reduction programs on a scientific basis are relatively new: (a) because most corporations are not yet certain of how to evaluate the success of current cost-cutting programs; however, nearly all believe that the results are most encouraging and that the savings resulting from the programs have more than justified the expenses incurred; and (b) in addition to the dollar savings, several companies believe that benefits have been gained in the form of closer cooperation among the various departments, thus making for a more smoothly operating organization.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Estate Tax—Survivor's Annuity—Comparable Provision Under 1954 Code

The Court of Appeals[1] recently affirmed the Appellate Division and held that where a member of the New York City Employee's Retirement System upon retirement selected an option giving him a reduced annuity for life and an annuity of one-half the amount to his widow for her life if she survived him, the exercise of the option constituted a taxable transfer and the value of the widow's annuity was includible in decedent's gross estate.

It had been argued that the imposition of an estate tax upon the annuity payable to the widow of a retired city employee was prohibited by Section 5 of Article XVI of the State Constitution and by Section 7 of Article V. Section 5 provides that "all salaries, wages and other compensation, except pensions, paid to officers and employees of the state and its subdivisions and agencies shall be subject to taxation." Section 7 of Article V made retirement system membership and benefits contractual, but the exemption of pensions from estate taxation had been abolished in 1930.

The court held the tax upon the annuity was not prohibited as a pension. It also held that the amount includible in the gross estate is the value at the time of decedent's death and not the value of the annuity at the time it was created. On this issue it overruled the Appellate Division.

The new 1954 (federal) Code for the first time contains a specific provision on the inclusion of annuities in the gross estate. (Section 2039). It provides for the inclusion in the gross estate of

> "the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 . . ., if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death."

This provision applies to survivor's annuities, whether the annuity was joint or otherwise, and to benefits under annuities arising out of a contract or agreement between the decendent and his employer.

The amount included in the gross estate will be based upon the value at the decedent's death of the payments to be made after his death. Annuities under certain trusts and plans are exempt. For example, an employee's trust forming part of a pension, stock, bonus or profit sharing plan which at the time of decedent's separation from employment was a qualified plan under

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[1] *Matter of Herman K. Endemann*, aff'g. 282 App. Div. 768; June 1, 1954.

Section 401(a). The exemption applies also to a retirement annuity contract purchased by an employer under a qualified plan [Section 401(a)(3)]. Even as to such trusts and retirement annuities, the portion attributable to contributions made by the decedent would be subject to the estate tax. The exemption is applicable to estates of decedent's dying after December 31, 1953.

Gross Receipts Tax—Significance of Payment Under Protest

Several recent cases have held that the New York City Gross Receipts tax was unconstitutional as applied to certain foreign corporations whose activities within the city were merely incidental to their operations in interstate commerce.[2] These cases have raised the question whether other such corporations, similarly situated, could recover back tax payments made without protest in prior years on the theory that such payments were made under a mistake of law.

In the *United Piece Dye Works* case, the court permitted recovery for two years in which protest was made, but disallowed recovery in one year when payment was made without protest. The taxpayer, however, failed to raise the question of payment made under a mistake of law.

The procedural provisions of the Gross Receipts Tax Statute itself make protest a prerequisite to a statutory claim for refund. It has been held, however, that a taxpayer against whom a tax is unconstitutionally levied may disregard the refund provisions of the taxing statute and bring a common-law action for money had and received.[3]

At common law, whether tax payments erroneously made were recoverable, depended upon whether they were made voluntarily or involuntarily. The rule in New York has long been that payments made without protest under a mistake of fact were considered involuntary and hence recoverable.[4] Up until 1942 it was equally well settled that payments made without protest under a mistake of law were deemed voluntary and were ***not*** recoverable.[5] However, in 1942, Section 112-F of the Civil Practice Act was enacted, which section provided that when relief against mistake is sought in an action it shall not be denied merely because the mistake is one of law rather than fact.

The question, not yet finally determined, is whether Section 112-F has pulled the two lines of cases together, so that payments made without protest under mistake of law are now as recoverable as those made under a mistake of fact.

One Supreme Court justice answered this question in the negative in *Egyptian Lacquer Mfg. Co.* v. *City*, (S. C., N. Y. Co.) N. Y. L. J. May 20, 1954, p. 7, and that case is now on appeal to the Appellate Division.

While the applicability of Section 112-F to the tax field has not previously been litigated, one point in the taxpayer's favor should be noted. In *Tanner* v. *Imperial Recreation Parlors*,[6] the court stated that Section

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[2] *United Piece Dye Works* v. *Joseph*, 282 App. Div. 60 (1953); *United Air Lines, Inc.* v. *Joseph*, 282 App. Div. 48 (1953). (Both cases were affirmed without opinion by the Court of Appeals on July 14, 1954). *National Steel Corp.* v. *City of New York*, 121 N. Y. S. 2d 61, aff'd., without opinion, 283 App. Div. 867 (1954); now on appeal to the Court of Appeals. See, also, New York State Tax Forum, July 1953 issue, pp. 465, 467.

[3] E.g., *National Steel Corp.* v. *City of New York, supra; New York Rapid T. Corp.* v. *City of New York*, 275 N. Y. 275 N. Y. 258 (1937).

[4] E.g., *Adrico Realty Corp.* v. *City of New York*, 250 N.Y. 29 (1928); *Bushwick Commission Co., Inc.* v. *Joseph*, S.C., N. Y. Co., N.Y.L.J., Jan. 25, 1952, at p. 345 (Gross Receipts Tax case).

[5] E.g., *Flower* v. *State*, 65 Misc. 145; aff'd., 143 App. Div. 871 (1911).

[6] 265 App. Div. 371; affirmed without opinion, 290 N. Y. 801 (1943).

112-F had changed the rule of *Newburgh Savings Bank* v. *Town of Woodbury,*[7] and the *Newburgh* case had been cited in several old tax cases, notably *Flower* v. *State, (supra.)* for the proposition that payments made under mistake of law were not recoverable.

Gross Receipts Tax—Apportionment Formula

In a recent case[8] the Court of Appeals invalidated the minimum allocation factor in the apportionment formula used where a taxpayer is engaged both in interstate and intrastate business. The formula calls for a three-factor allocation based upon property, wages and receipts within and without the state. Under the regulations for the gross receipts tax [Article 211(I)] the three factors are averaged. If the average of the percentages exceeds 66⅔%, the maximum allocation may not exceed 66⅔%. However, if the average is less than 33⅓%, there is a minimum allocation of 33⅓%. The court held that in using the minimum figure, the Comptroller acted arbitrarily, since it was the declared legislative purpose to tax only that portion of interstate receipts that was attributable and allocable to business carried on in New York City.

The court concluded that where a taxpayer carried on its activities within and without the city, a share of the receipts from interstate sales could be included in the measure of the gross receipts tax. For this conclusion it relied on the authority of the case of *Oliver Coat Co.* v. *McGoldrick*[9] and *Specter Lines* v. *O'Connor.*[10] But in applying the minimum figures set up in the formula the comptroller did not reasonably and lawfully measure the tax. In the *Oliver Coat Co.* case, each of the three factors had some degree of relation to local activity and therefore in making an allocation, rough approximation is all that is required. In that case the court did not pass on the prescribed minimum of 33⅓%. The allocation fraction in that case was 55.75%. In the *Gulf Oil Corp.* case the Comptroller made no attempt at an approximation in setting up the minimum percentage. The court held further that the local law discriminates against the taxpayer in favor of those engaged solely in intrastate activities, since an unfair apportionment by one state could result in multiple taxation discriminating against the taxpayer as one engaged in interstate commerce.

The Comptroller had also argued that the taxpayer could have used the alternative formula provided in Article 210 of the regulations. To this the court said that the availability of an alternate formula, possibly not arbitrary, does not save the formula actually used which is arbitrary.

In this case for three of four years involved the computations under the three factor formula were 32.2%, 33.08% and 31.84%. These percentages were raised to the minimum of 33⅓%. The taxpayer had argued that the receipts factor was weighted in the city's favor.

Gain from the Sale of an Oil and Gas Lease

Deputy Commissioner Kassel recently[11] issued a ruling holding that gain realized from the sale of oil and gas leases used in the taxpayer's business of producing oil and gas did not result in capital gain, but was ordinary income. The lease was not a capital asset. That term is defined in Section 350(12) and excludes property held for customers in the ordinary course

[7] 173 N. Y. 55.

[8] *Gulf Oil Corp.* v. *Joseph,* Court of Appeals, July 14, 1954, reversing 283, App. Div. 309.

[9] 261 App. Div. 1070; aff'd., without opinion, 287 N. Y. 769.

[10] 304 U. S. 602.

[11] July 12, 1954.

of business. It also excludes land used in the business and depreciable property. The state law has no provision similar to Section 1231 of the 1954 Code [formerly 117(j)] permitting capital-gain treatment for such assets in the case of gain and ordinary income treatment in the case of a loss.

The opinion goes on to determine the nature of the oil and gas lease. To a dealer in such leases it would be property held primarily for sale to customers and excluded on that ground from the definition of capital assets. In the hands of an operator, oil and gas leases might be capital assets unless they constituted land used in the business. The opinion states that for tax purposes land and real property have generally been construed to include oil and gas leases. The opinion cites as authorities Section 39 of the General Construction Law, *Matter of Hazelwood Oil Co.*,[12] Section 2, sub. 6, of the Tax Law defining the term land, and an opinion of the Attorney General holding that unexercised oil and gas rights in real estate are subject to the real property tax.[13]

The opinion also considers the question of whether the status of such leases as real or personal property should be governed by the law of the state of situs of the land. The opinion notes that with respect to estate taxes, that is the law, since the jurisdiction to impose the tax is dependent upon the nature of the property interest.[14] The situation under consideration by the Commissioner involved a nonresident and he is taxable on gains realized from the sale of oil and gas leases in this state. No question arises concerning the nature of such interests in other states. A New York resident is taxable on income derived from any source and a tax on such income is not a tax on the property which produces it.[15]

The opinion also notes that

> "the Supreme Court of the United States has held[16] that for federal income tax purposes, persons sharing in the depletion allowance with respect to oil leases are characterized as owners of economic interests in oil or mineral in place regardless of the technical provisions of the instrument creating the lessee's interest."

They are thus real property excluded from the definition of capital assets if used in the taxpayer's business.

Revision of Return

In a recent case[17] the Tax Commission revised a return on the basis of the information submitted on the tax return. The taxpayer had computed the gain from the sale of a grocery store as a capital gain. The Commission requested additional information which the taxpayer failed to furnish. The Commission thereupon refunded the capital gain tax and held the taxpayer subject to the normal tax and unincorporated business tax.

In an action brought by the taxpayer the Tax Commission made a motion for summary judgment dismissing the complaint, which the court granted. The court held that since the Tax Commission had sufficient information to justify an opinion that the tax return was incorrect in some essential respects, it acted within the proper exercise of its administrative powers in revising the return. The taxpayer's remedy was a request for a hearing under Section 374, and thereafter a right to review the Commission's determination by certiorari under Section 375. The taxpayer had failed to avail himself of the statutory remedy within the prescribed time.

12 195 App. Div. 23.

13 1940 Op. Atty. Gen. 320, 323.

14 *Blodgett* v. *Silverman*, 277 U. S.; *Frick* v. *Pennsylvania*, 268 U. S. 473.

15 *Peo. ex rel. Cohn* v. *Graves*, 300 U. S. 308.

16 *Palmer* v. *Bender*, 287 U. S. 551; *Thomas* v. *Perkins*, 301 U. S. 655.

17 *Morse* v. *State Tax Com.*, Sup. Ct. Special Term, June 14, 1954.

It should be noted that the sale of the store was in connection with the sale of the grocery business. The real property had been used in the conduct of the business and did not come within the definition of capital asset.[18]

This case was not like *Brown* v. *Tax Commission*[19] where it was alleged

> "that the Commission without any information or facts before it to justify an opinion that the return was incorrect, made an arbitrary and unwarranted additional assessment for the sole purpose of extending the statutory period within which a revision of the return might be made."

Estate Tax—Marital Deduction

For estate tax purposes, both under the federal law and the state law, a deduction from the gross estate is allowed for the value of any interest in property which passes or has passed from the decedent to the surviving spouse, subject to certain limitations. This is known as the marital deduction. It was first introduced in the Internal Revenue Code in 1948, and the state law in 1950. The idea behind the marital deduction is that the interest passing to the spouse will be taxable in the estate of the spouse. For that reason such interest generally may not be a terminable interest.

The Internal Revenue Service recently[20] issued a ruling disallowing a marital deduction where the proceeds of a life insurance policy were payable to a decedent's wife only if she was living when the insurer received due proof of decedent's death. Section 812(e)(1)B of the 1939 Code,[21] Section 249-s, 4(b) of the state law, provide that the marital deduction is not allowed if an interest in the same property also passes to any person other than a spouse and such person may possess or enjoy any part of such property after the termination of the interest that passed to the surviving spouse. Incidentally, the 1954 Code liberalizes this provision somewhat by allowing the marital deduction with respect to that part of the property in which the interest does not terminate. The state will undoubtedly make a similar change in its law.

The interest passing to the spouse is not deemed to be a terminable interest if the death of the spouse occurs within a period of six months after decedent's death. It also will not come within the terminable interest rule if the death of the spouse occurs as a result of a common disaster.

The ruling cites the case of *Kellar* v. *Kasper*[22] which involved a bequest to a surviving spouse, if she should be living at the time of distribution of the bequest. The court there held that the marital deduction would apply. The government appealed the case to the Eighth Circuit.

The right to the marital deduction where the interest of a spouse is terminable came before the Tax Court in another case[23] recently. The proceeds of life insurance policies were payable to a wife in installments. The policies contained a provision that the payments would terminate upon the wife's death. If prior to that time all the proceeds had not been paid to her, the interest in the unpaid portions would pass to contingent beneficiaries. This was held to be a terminable interest. The spouse did have the privilege of changing the settlement option. Under the options the contingent beneficiaries might share in the proceeds subject to no power in the surviving spouse to appoint all amounts payable under the contract. As a beneficiary, the wife

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[18] Matter of *Appleby* v. *Bates*, 278 App. Div. 12, 103 N. Y. S. (2) 317.

[19] 199 Misc. 349; aff'd., 279 App. Div. 837; aff'd., 304 N. Y. 651.

[20] Rev. Rul. 54-121, Internal Revenue Bulletin, April 5, 1954, page 8.

[21] 1954 Code, Sec. 2056.

[22] U. S. Dist. Court, W. D., South Dakota, Civil Action No. 424, July 29, 1953.

[23] *Estate of Thomas J. White*, Docket No. 43740, 22 T.C., No. 83, June 23, 1954.

could have made herself the sole beneficiary and provided a method of payment under which she would have received all of the proceeds. She made no change of any kind which might have allowed the marital deduction.

In another case[24] a decedent left property in trust, the income to be paid to his wife for life, with a power to invade the corpus. Such a provision qualifies for the marital deduction. But there was a proviso that the wife would have no power to take down the corpus if she became legally incapacitated or if a guardian of her person or estate should be appointed. The law provides that the power must be exercisable "in all events" and the court held that the proviso did not give her the complete power without any qualification.

There was a dissenting opinion which held that the mere possibility that the wife would be deprived of her right to withdraw the property should she be declared incompetent was not a valid reason for denying the marital deduction. If the will were silent on the mere possibility of the beneficiary's legal incompetence, the deduction would not have been lost.

Gross Income—Payments Under a Will Contest

A recent case[25] held that the payments made under an agreement with beneficiaries of a testamentary trust whereby the taxpayer was to receive a specified sum monthly for life, were taxable as income.

The beneficiaries agreed to transfer certain stock and accumulated dividends received up to the time of the agreement to the trustee. The trustee was to use dividends received thereafter to make the monthly payments. The balance of any dividends received would be paid to the beneficiaries under the will. The transfer of the stock and accrued dividends was made to secure the payments to the contestant taxpayer. The trustee had the right to sell the stock provided he invested the money in United States government bonds in an amount sufficient to produce the income necessary to pay the monthly annuity.

The Tax Commission held that the agreement provided only for payments of income, with no provision for the invasion of the principal. Under the rule in *Helvering* v. *Butterworth*[26] the payments would not be taxable income if they constituted an annuity and if the corpus could be invaded. The taxpayer held that the use of the word "annuity" in the agreement made her an annuitant under the decision. The court held that the trust fund was intended to be preserved intact for the remaindermen under the will. There was no power under the agreement to invade the corpus. The mere fact that the payments were described as an annuity was not sufficient to exclude them from taxable income.

[24] *Estate of Frank E. Tingley,* Docket No. 45229, 22 T. C., No. 54, May 26, 1954.

[25] *Harte* v. *Chapman,* App. Div., 3rd Department, March 31, 1954.

[26] 290 U. S. 365.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Is It Important to Read the Entire Registration Statement and the Underwriting Agreement?

The Registration Statement

The accountant who participates in the preparation of a registration statement is concerned primarily with the examination of the financial data to which his certificate relates. The accountant should make it a rule, however, to read carefully the entire registration statement — not merely the financial data. There are several reasons for this.

In the first place, the accountant is interested in making sure that the representations in the so-called "narrative" (as opposed to the financial) section of the registration do not conflict with the representations in the financial section. If there are any conflicts between the two, obviously they must be resolved.

Second: in the usual case, except for the registrant's own people, there are few persons as familiar with the affairs of the registrant as the certifying accountant. For this reason the accountant frequently has helpful suggestions to make with respect to the narrative section of the registration. The information in the narrative section is frequently prepared under the supervision of the company's counsel or underwriter's counsel, and they always welcome any comments, suggestions or criticisms which the accountant may have as a result of his having read the entire registration.

Third: there may be material in the narrative section of the registration which should be cross-referenced in the financial section. For example, if the narrative section discloses a recent material increase in wages or other costs which are not reflected in the financial statements or have been reflected for only a short period, it may be desirable in the financial section to disclose these recent increases in costs and expenses. The most practicable way of making this disclosure is by a simple cross reference to that section of the narrative which contains the information in question. Similarly, if the narrative section discloses a recent substantial increase in rates or changes in selling price of products, and these changes have not been reflected in the financial statements, these changes also may warrant a disclosure in the financial section—either by a cross reference to the narrative section of the registration or by repeating the matter in question in the financial section.

Fourth: there may be information in the text of the registration statement which deals with a question which is also required to be included in the financial section. For example, the notes to financial statements must set forth the provisions of the company's pension plan if it has one, including a brief description of the plan together with a statement as to the annual cost thereof and a disclosure as to the unfunded cost of credits for service rendered prior to the adoption of the plan. The matter of pensions is often set forth in the section of the prospectus dealing with employee relations or under a similar heading. Rather than repeat all this information in the statements, it is desirable to make a cross reference in the notes to the statements to that section of the prospectus which sets forth the material otherwise required to be included in the financials. Sometimes as originally drafted by counsel for the company or the underwriters, the discussion as to

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pensions does not give all the information that would be required in the financial section. Everybody concerned with the preparation of the registration document is desirous of making the document—especially the prospectus—as condensed as is consistent with the responsibilities assumed under the 1933 Act. If, therefore, the accountant suggests that by adding a sentence or two to that section of the narrative dealing with pensions, he will be able to omit a long-winded discussion regarding pensions from the financial statements, he can be reasonably sure that his request will fall on sympathetic ears.

The Underwriting Agreement

As soon as he can conveniently do so, the accountant who participates in the preparation of a registration statement should make it a point to read the underwriting agreement. At the time of the initial filing with the SEC the agreement is usually tentative and unsigned. Usually the underwriting agreement becomes final and is executed shortly before the public offering date of the securities to which the registration statement relates. The accountant, however, should not wait until the underwriting agreement is signed; he should read the agreement as soon as he can get a draft of it. At that time there is usually agreement in principle as to what is expected of all parties in the agreement. The most important omissions are those relating to price which are not the accountant's concern.

There are a number of reasons why the accountant should make it a point to read the draft of the underwriting agreement before it is final. In the first place the underwriting agreement frequently contains provisions which affect the accountant in one way or another. For example, the agreement often provides that on or before the "closing date" the certifying accountant is to issue a letter or report in which he states that the financial statements, supporting schedules, and summary of earnings covered by his certificate comply with the requirements of the Securities Act. Also, the accountant may be required to report to the underwriter concerning a review of any unaudited financial statements or summary of earnings included in the registration statement. Frequently also the underwriting agreement contains a provision to the effect that the accountant is to issue a letter concerning any adverse changes in the financial condition of the company otherwise than as disclosed in the registration statement or prospectus. Some underwriting agreements also contain a provision that the accountant is to issue a separate letter or report to the underwriters concerning the tax situation of the company and its subsidiaries.

Second: underwriting agreements sometimes contain provisions requiring an accountant's opinion covering such matters as the amounts of additions to and retirements of fixed assets during the last five years. Where the matter in question is as simple as this, the accountant may be able to comply with this provision of the underwriting agreement without much, if any, additional work.

Underwriters and their counsel are sometimes under the impression that the accountant who certifies the financial statements is also in a position to certify almost any figure in the registration document. As a result, their agreements sometimes require the accountant to review and report on matters which he does not ordinarily go into in the course of his annual examination. These and similar provisions are not the result of SEC requirements; they supplement the investigation made by an underwriter before offering securities of an issuer to the public. The underwriting agreement may provide, for example, that the accountant is to certify to the underwriters the remuneration paid to officers and directors, or a break-down of sales. These are matters with which the accountant may be generally familiar, but which he may not be in a

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Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Time Records for Staff and Partners

Time records of staff, partners, and of office personnel performing chargeable services, are an essential record, for various purposes, in small and large accounting offices. These records take various forms dependent on the size of the staff and the attitudes of the principals.

A form that was described at one of the technical sessions of the recent convention of the American Institute of Accountants, that is used by a small, progressive accounting firm, is worthy of consideration.

All members of the organization have a pad of forms, in duplicate sets, which constitute time record blanks. On each slip are recorded the name of the client, the nature of the services and comments, and the date and time involved. One page of the form is placed into an unbilled services file arranged by clients. The second is filed according to the personnel.

The first group of forms is summarized at least monthly as to personnel and accumulated time for each. This information is used for billing purposes and to determine the amount of work in process whenever that information is desired. The second group of forms is used to keep record of each person's productive and nonproductive time. It was pointed out that the system eliminated postings to client records by use of a filed duplicate of an original time record.

If the slips will also disclose special matters dealt with and unusual accomplishments by way of advice and suggestions, the record acquires added value for fee negotiation use.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

Per Diem Rates vs. Contract (Retainer) Fees

Another point brought out at the Institute convention by a member of the Office Practices Panel was his observation that there was some trend away from the per diem basis of billing to fixed fees determined preferably at the close of the engagement. The reason for this trend is that the time basis does not reflect the extraordinary accomplishments. More than just time is involved in the consideration of the value of personal services.

It is not going to be possible to convert all clients now on some other fee basis to the proposed method, but it is worth trying. Some clients may recognize the inherent fairness of that method. New clients, however, may prove to be more tractable in that respect.

Inquiries Into Insurance Coverage

Accountants are not expected to be insurance experts but they nevertheless can do some good in this field. Certain areas lend themselves readily to inquiry during the audit. For example, compensation insurance involves a breakdown of the payroll by job classifications, rates for each group, and overtime pay that is exempt (dependent on state laws or policy provisions). Perusal of the classifications may disclose even to an untrained but

intelligent observer that some group of employees may have been placed into a more hazardous, higher rate category than appears to be warranted. These matters should be brought to the attention of clients for follow-up by them. Experience proves that many corrections and savings have developed from this type of inquiry by accountants.

There are many facets to insurance and it is an ever-changing situation. While adequacy of coverage is a major consideration, attention must also be given to the possibilities of economies in premium expense that result from effective and correct utilization of the insurance available.

Someone in an accountant's office should make it a point to gather insurance "pointers" for his own use and for dissemination to others in the organization. This can be a most beneficial service to clients, and, as a consequence, to the accountants. This type of information is obtainable from trade and accounting publications, books on insurance, insurance company literature, and by information obtained from men in the insurance field.

Getting Closing and Adjusting Entries to Clients

Here is a province of administration of a practice that may be a neglected one as to uniformity of methods, timeliness, economy of effort, and correctness of the data.

How are these entires transmitted to the client—by the staff man on the job or by mail?

When are they delivered — before final review or after final review?

Are the adjusting entries, if delivered or mailed, copied from the entries in the work paper file, or are they pencil-carbon duplicates?

What do you do to make sure that the client gets the entries at a reasonable time and that they are correct and complete?

Can you devise standard procedures and forms for the preparation, and for the transmittal letter?

Thought to these questions, and others that may be raised by them, may make it possible to routinize what may otherwise be a disorganized situation.

Book Reviews

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Accountants' Legal Responsibility

With a Collection of Leading Cases and Articles, by Saul Levy. AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1954. Pages: vii + 288; $5.00.

Some of the problems most frequently encountered at the offices of our Society involve the ownership of accountants' working papers, questions of privilege in connection with testimony to be given as an expert accountant, and the matter of possible liability to clients and/or third parties arising out of the issuance of accountants' reports. The answers to these and many other similar or related questions are to be found in this excellent work.

The first part of this book was originally published as Chapter 6 of the CPA Handbook. However, because the considerable reader interest in the subject, it was decided to reprint the material in more convenient form, and to augment it with Part II, consisting of 220 pages of basic source material on the subject.

The author, Saul Levy, is singularly qualified to write in this field. He has practiced both public accounting and law on his own account for 35 years, participating in several of the leading cases on the subject of the responsibility of accountants. He is a past president of our Society and a member of the Executive Committee and Council of the American Institute of Accountants.

This is a book which should be in every accounting office, to be studied carefully when acquired and referred to as often thereafter as relevant problems arise. Accounting teachers would also do well to include it on the list of suggested readings for their auditing classes.

E. S.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Some Payroll Tax Consequences of the 1954 Internal Revenue Code

The 1954 Code has granted the individual an extra month from March 15th to April 15th 1955, within which to file his 1954 federal income tax return. The question arises as to whether or not employers might get comparable relief with respect to the present January 31st, 1955, deadline for the preparation and filing of forms W-2 on all subject employees, showing total wages, social security wages, withholding and social security tax deductions.

In prior years, if the deadline could not be met, the remedy on the part of the employer was to request an extension of time for the filing of forms W-2 and the summary form W-3. An extension of time, if granted, would run for 15, or 30 days where there were exceptional circumstances set forth in the application to the District Director of Internal Revenue, who was generally unwilling to grant extensions for any period of time because of the tight tax reporting time schedule.

Under the new procedure started this year, Withholding Tax Reconciliation and Summary form W-3 has been discontinued. Instead, the reconciliation must be made on Schedule "C" printed on the back of form 941, Employer's Quarterly Federal Tax Return. The deadline for the filing of form 941 for the fourth quarter of 1954, is January 31st, 1955; or if the return is accompanied by depositary receipts, forms 450, showing timely deposits in full payment of the taxes due for the entire calendar quarter, the return may be filed on or before February 10th, 1955.

It would appear, therefore, that the taxpayer may obtain an automatic extension of time until February 10th, 1955, for the filing of his forms W-2 for the calendar year 1954, by paying fourth quarter 1954 Employer's Quarterly Federal Payroll Taxes with depositary receipts entirely, instead of by a combination of Depositary Receipts and check, as is the general practice where more than $100 a month is deducted from employees' wages for Federal payroll taxes, and sending the W-2 forms along with the form 941.

The Internal Revenue Service requires that the W-2 forms must be filed with an adding machine tape or list showing the amount of withholding tax on each W-2, and a reconciled total figure of all the W-2s and the quarterly tax amounts paid during the year. Despite this foregoing means of obtaining more time within which to file forms W-2 after the close of the year, the Treasury Department should make further provision for more time to file these information returns which swamp very many employers and their accountants, faced each year, with an almost impossible deadline, considering the amount of work required for the preparation and filing of accurate, reconciled Withholding Tax Statements.

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committee on State Taxation and Chairman of the Sub-Committee on Unemployment Insurance.

Penalties for Failure to File Forms W-2 or 1099

The new Code provides for a $1 fine for each Withholding Tax Statement

or Form 1099 required by the Internal Revenue Service and not filed by the employer, unless such failure is due to reasonable cause and not to willful neglect. The total amount of these $1 penalties that may be imposed on any one employer during any calendar year is limited to $1,000, for such delinquency.

New Types of Exemptions for Employee Withholding Tax Purposes

In the past, a taxpayer could claim withholding exemptions for dependent members of his immediate family including adopted children, and certain other blood relatives, provided the taxpayer contributed more than one-half of the support of each dependent who had to be a citizen of the United States or a resident of the United States, Canada, or Mexico, with less than $600 in gross income received by the dependent during the tax year.

Under the 1954 Code, the $600 gross income requirement has been dropped with respect to children under 19 at the close of the calendar year, and for student dependents who are in an educational institution full-time for 5 calendar months in a taxable year.

There is a new "multiple support" rule for claiming dependents. It operates in this way. A group of individuals collectively contribute more than 50% of a dependent's support, with each contributing more than 10% and no one contributing more than 50% of the dependent's support. They may agree among themselves as to which one will take the exemption. The others will be required to file declarations that they will not claim dependency deductions for the dependent for any taxable year beginning in a calendar year with regard to which the fractional part of the dependent's support had been rendered.

An unadopted foster child, living in the household of the taxpayer, may be claimed as a dependent. A cousin who formerly resided with the taxpayer and is presently confined to an institution for physical or mental care may be claimed as a dependent. A dependent claim may be made for a dependent alien who resides in the Canal Zone or the Republic of Panama. A deduction as a dependent can be claimed by a taxpayer who was a member of the armed forces at the time, for a child born to the taxpayer or legally adopted by him, in the Philippine Islands, prior to July 5th, 1946, even though the child is presently a resident of the Philippines.

Withholding Tax on Fair Value of Meals and Lodging

The 1954 Code grants an exclusion from gross income to the employee for meals furnished to the employee on the premises of the employer for the convenience of the employer. A similar exclusion is made for the fair value of lodgings furnished to the employee by and for the convenience of the employer on the business premises. It would appear therefore that no withholding taxes are required for the fair value of the board or lodging provided to the employee under these circumstances.

Undelivered Year 1954 Withholding Tax Statements for Former Employees

Forward to the District Director of Internal Revenue with the 1st quarter 1955 form 941, copies B and C of form W-2 that cannot be delivered to former employees after diligent effort to do so has been made by the employer, even though the employee has moved without leaving a forwarding address or for some other reason preventing delivery.

Employee copies of form W-2 for prior years which the employer has not been able to deliver despite reasonable efforts to do so, should be retained by the employer as part of his payroll records unless such copies have been requested by the District Director.

Unemployment Insurance—Some Recent Decisions—Termination of Industrial Controversy

In a decision handed down by the Appellate Division recently, the question of the right of some former employees to collect benefits after losing their employment as the result of an industrial controversy, was decided in favor of the claimants even though the "seven-week" suspension period provided in the statute had not run completely.

The law provides that employees who lose their employment due to industrial controversy, such as strike or lock-out, or voluntary quit without good cause, or for misconduct connected with their employment, must be suspended or penalized with an extended period of time beyond the normal one-week waiting period, before they can receive their first unemployment insurance check. Employers whose former employees are collecting benefits after the loss of employment may have been due to any of the circumstances mentioned, should be advised that their unemployment insurance tax rates for coming years may be unjustifiably increased unless they look into these matters. They may pay less tax in the future if they pay more attention to present claims.

More Attention to Unwarranted Benefit Charges Necessary

Of course an employer who wrongly protests a former employee's benefit claim, by requesting a hearing before the Unemployment Insurance Referee or Appeal Board, may lose the $10 Referee, or $25 Appeal Board deposit that he must pay before his hearing request will be granted. So it is important to be familiar with the rules, or to seek guidance through the services of an expert in the field of unemployment insurance, who is familiar with the law and decisions, of which there are thousands handed down each year and regularly each week throughout the year. In *Matter of Lasher, et al.* (Appeal Board Case numbers 38,469-53 and 38,474-53), decided by the Appellate Division on June 18th, 1954, and unanimously affirming the Appeal Board, the Court stated:

> ". . . The two claimants involved in this appeal are structural steel workers who had been working for the Bethlehem Steel Company. On October 3, 1949, they stopped work because of an industrial controversy. A week later, on October 10th, 1949, the claimants went to work for another employer in another community. After 6 days of work they were laid off and filed claims for unemployment insurance benefits. The Unemployment Insurance Appeal Board has held that the disqualification arising from the industrial controversy terminated when the claimants obtained employment with another employer. The Industrial Commissioner appeals. We think the Appeal Board correctly decided the question. The statute provides . . . the accumulation of benefit rights by a claimant shall be suspended during a period of 7 consecutive weeks beginning with the day after he lost employment because of an industrial controversy in the establishment in which he was employed. It also provides that this disqualification does "not run after the industrial controversy is terminated. We think that the sense of this is that when an employee who stops work because of an industrial controversy enters into the employ of another employer the effect as to him at least is the cessation of the industrial controversy. Other disabilities have been regarded as terminated under similar conditions. It has been held for example that the penalty for leaving employment without good cause ends when the claimant accepts a new employment (*Matter of Mittleman* (*Corsi*), 282 App. Div. 587) and the penalty for refusal to accept employment wthout just cause ends when new employment is accepted (*Matter of Weinberg* (*Corsi*), 282 App. Div. 795). The disability here should be treated similarly. . . ."

While the court did not expressly say so, the employment required to break the suspension period should be "bona fide" employment.

Referee Reversed in Setting Aside 2 Ten-Dollar Request Reporting Penalties

The Appeal Board again reversed another attempt by a Referee who listened to the facts as testified to by witnesses, at hearings, who sought to show that the filing of wage request reports beyond the 7-day statutory period was not under such circumstances as would permit the cancellation of the penalties. This is another one of very many cases that have been decided against employers because of the inelastic and stringent provisions in the present statute. In Appeal Board Case #45,145-54 et al., the Appeal Board felt it could not accept the referee's conclusion that the reports were filed late because the original requests had never been received by the employer despite sworn testimony to that effect. The Appeal Board stated:

> ". . . The mailing of the demands in question on the dates stated having been established to the satisfaction of the Board, there arises therefrom a presumption that the same were delivered to and received by the addressees in the regular course . . ."

Legislative Action Urged to Remedy Ten-Dollar Penalty Problems

In the face of such almost impossible obstacles it again seems high-time that the next session of the state legislature take cognizance of the difficult and arbitrary position that accountants and their clients face when these nuisance ten-dollar penalties are imposed. This penalty should be repealed outright or imposed only where it is shown that the employer has been guilty of willfully failing to file the request report on time. Provision should also be made for an extension of the time period beyond the present arbitrary 7-day period. A 2-week (or perhaps longer) period can be provided without creating any great hardship in the administration of the law.

Accounting at the S.E.C.

(Continued from page 714)

position separately to certify without undertaking some additional work.

Accountants are glad to assist in the preparation of the registration statement in any way compatible with their position as independent experts. Thus, some of these provisions in underwriting agreements, while outside the scope of the usual audit engagement, can be complied with, but it is important to find out about them before the agreement is executed, not at the closing when the securities are delivered and paid for. Also, if the provisions of the agreement involve a considerable amount of work on the part of the accountant, this may have an important bearing on the client's willingness to have the work done. If the cost of the additional work is disproportionate to its value, the underwriter also may be agreeable to eliminating that particular provision of the agreement.

Third: when the underwriting agreement provides that the accountant is to furnish letters as to compliance, adverse changes, etc., it is advisable to clear with interested parties in advance the form of letters, opinions, etc. proposed to be issued in satisfaction of the underwriting provision. The point here is to have agreement in principle as to the form these letters are to take. At the "closing" there is no time to resolve differences between the accountant and the underwriter. For this reason, it cannot be stressed too strongly the desirability of clearing the form of these letters with interested parties in advance of the closing date.

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